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RETIREMENT SAVINGS 2.0: UPDATING SAVINGS POLICY FOR THE MODERN ECONOMY

HEARING BEFORE THE COMMITTEE ON FINANCE UNITED STATES SENATE ONE HUNDRED THIRTEENTH CONGRESS SECOND SESSION

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RETIREMENT SAVINGS 2.0: UPDATING SAVINGS POLICY FOR THE MODERN ECONOMY

TUESDAY, SEPTEMBER 16, 2014

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Ron Wyden (chairman of the committee) presiding.

Present: Senators Stabenow, Cantwell, Nelson, Cardin, Brown, Casey, Hatch, Grassley, Crapo, Thune, and Portman.

Also present: Democratic Staff: Kara Getz, Senior Tax Counsel; Todd Metcalf, Chief Tax Counsel; and Joshua Sheinkman, Staff Director. Republican Staff: Preston Rutledge, Tax Counsel; and Jeff Wrase, Chief Economist.

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The Finance Committee will come to order.

When you take a look at the state of retirement savings in America, it is clear that something is out of whack. The American taxpayer delivers \$140 billion each year to subsidize retirement accounts, but still millions of Americans nearing retirement have little or nothing saved. The fact is, the incentives for savings in the American tax code just are not getting to those who need them most.

A pair of new studies spells out the issue. The Federal Reserve found last month that an employee with middle-of-the-pack savings has about \$59,000 set aside for retirement. Yet, according to the Government Accountability Office, some 9,000 taxpayers have IRA accounts worth more than \$5 million. It would take several lifetimes of work for the typical middle-class American to save that much money.

[The report from the Government Accountability Office appears in the appendix on p. 218.]

The CHAIRMAN. So how did those massive IRA accounts come to be? In many cases, they seem to be sweetheart stock deals that most investors would never have access to. Executives buy stocks at a special rock-bottom price—sometimes fractions of a penny per share—and use an IRA as a tax shelter. The stocks start out dirt cheap, but just like that, they turn to gold, and the IRA shoots up in value.

Now, wise investors have every right to use all of the tools available to them, and no one should begrudge them their success. But IRAs were never intended to be a tax shelter for millionaires. They were designed to help the typical American save for retirement. As the Finance Committee continues to work on modernizing the tax code, it needs to take a good and bipartisan look at fixing this issue. With limited resources, it is crucial to use taxpayer dollars as wisely as possible.

The same study from the Federal Reserve included another alarming piece of information. Nearly a third of workers, according to the Fed, have no pension and nothing set aside for retirement. It is a fact of today's economy that millions of Americans are walking on an economic tightrope and are unable to save.

Report after report has shown that America's middle class is, at best, struggling to stay afloat. Five years after the Great Recession, it remains tough for many people to find and keep a steady job. The cost of a college education continues to rise. Millions of Americans had their wealth tied up in their homes before the housing collapse, and they are not yet close to a full recovery. And many working families continue to see their take-home pay drop.

At the same time workers, especially younger ones, are changing jobs more frequently than ever before, and they find it difficult to save without portable savings accounts. Women face special challenges to saving that have to be addressed as a part of tax reform. That is also true of part-time workers. This "Leave it to Beaver" ideal of a worker spending 40 years with one firm and then retiring with a generous pension and a gold watch is sorely outdated.

Retirement policies need to keep up with the times, and the Finance Committee is beginning today to examine those savings issues. One proposal worth looking at is being pursued by my home State of Oregon. Less than half of Oregon businesses offer retirement plans to their employees, and many Oregonians have trouble saving anything at all. So the State set up a Retirement Savings Task Force to look at solutions.

Just yesterday they recommended the State set up an auto-IRA program for any Oregon worker who is not covered by an employer retirement plan. A percentage of employees' paychecks would go into the savings accounts, and the contributions would rise with time. It would not be mandatory. Employees could opt out at any time, but it certainly has the potential to be a first step towards retirement security for many Oregonians.

In my view, the tax code should give all Americans the chance to get ahead, and making it easier to save is one of the best ways to accomplish that. That is why it is important for the committee, on a bipartisan basis, to look at how to improve these savings incentives and ensure that they help middle-class Americans prepare for retirement and not just set up tax shelters for millionaires.*

[The prepared statement of Chairman Wyden appears in the appendix.]

*For more information, *see also*, "Present Law and Background Relating to Tax-Favored Retirement Savings," Joint Committee on Taxation staff report, September 15, 2014 (JCX-98-14), <https://www.jct.gov/publications.html?func=startdown&id=4665>.

The CHAIRMAN. Senator Hatch, I look forward to working with you, as always, on a bipartisan basis on this, and I welcome your statement.

**OPENING STATEMENT OF HON. ORRIN G. HATCH,
A U.S. SENATOR FROM UTAH**

Senator HATCH. Thank you very much, Mr. Chairman.

I think this is an important hearing. It is an important topic, and we have an outstanding panel of witnesses. I think we are going to have a very interesting discussion.

Retirement policy has always been an especially important topic to this committee. It also has always been bipartisan. Most of the major pieces of retirement legislation that Congress has passed in recent decades have been named for Senators from the committee—one from each party. I am talking, of course, about legislation like Bentsen/Roth, Roth/Breaux, Grassley/Bob Graham, Grassley/Baucus/Hatch/Pryor, which, in the other body, came to be known as Portman/Cardin, for the two excellent legislators that I am proud to say are now colleagues of ours on this committee.

I believe this tradition of bipartisanship on these issues can and will continue.

Mr. Chairman, during the recent Highway Bill markup, we agreed to work together on multiemployer pension reform. That was done in the spirit of bipartisanship. And I have a pension reform bill for the modern economy that just last week received high marks from the Urban Institute, and I hope you will work with me on that as well. In fact, it received the highest marks. It is my sincere hope that the tradition of bipartisanship in retirement policy will continue and that the next retirement bill that comes out of this committee and becomes law will be known as Wyden/Hatch.

We have always had incentives in the tax code to encourage saving for retirement. As the late Chairman Roth was known for saying, “There are no bad savings.”

Congress has revisited saving incentives on occasion with an eye toward improving the incentives and increasing savings. For example, in 2001 Congress increased the limits for contributions to 401(k) plans so that today a worker may contribute \$17,500 to a 401(k) and \$5,000 to an IRA. Congress also added a “catch-up” contribution feature to the code to allow workers to contribute several thousands of dollars more beginning in their 50s, an age when many workers finally get serious about saving and when workers, including spouses, primarily women, who might have left the workforce for a time, finally have the opportunity to save again.

As reported in the Bluebook published at the time by the Joint Committee on Taxation, Congress believed it was important to increase the amount of employee elective deferrals allowed under such plans, and other plans that allow deferrals, to better enable plan participants to save for their retirement.

Well, it worked. Since 2000, retirement assets in defined contribution plans have grown from \$3 trillion to nearly \$6 trillion, despite the market downturn in 2008. Assets in IRAs have grown from \$2.6 trillion to \$6.5 trillion. In fact, increased contribution limits worked so well that, in 2006, Congress made those provi-

sions permanent, and the vote to make them permanent was overwhelming: 93 to 5.

The retirement policies we have pursued have always been about helping Americans to help themselves save more of their hard-earned money, not less. In the last 25 years, Democrats and Republicans have worked together to respond to a mutually shared goal: expanding savings among workers. Republicans agreed to proposals targeted to lower-income workers, like the savers credit. Democrats agreed that small business owners and managers needed to have some tax benefit skin in the game to take on the burdens of adopting and maintaining retirement plans.

In these areas, members from both parties have resisted partisan impulses, and, as a result, we have been able to craft good policy. Lately, however, I have become concerned that there is a political strategy by some in Congress to turn pension policy into just another partisan battleground. They would turn retirement policy into another front in the class warfare that consumes so much energy on some of the other committees in Congress. I am worried that some want to disregard the bipartisan good will of the last 25 years. That would be unfortunate. I especially hope it does not happen in our hearing today.

Mr. Chairman, what I hope to hear today from the witnesses are facts that can inform our policy considerations. We need to know how much income Americans are projected to need in retirement, how much are they projected to have, and, if there is a shortfall, what policies they recommend we enact to help Americans close the gap.

What I hope to not hear today are poll-tested slogans like "Upside Down Tax Incentives," "Bang for the Buck," "Pension Stripping," or "The System is Rigged" without substantiating data. We need to hear facts and serious policy proposals, not political slogans.

I want to thank you again, Mr. Chairman, for holding this hearing.

Let me just say I would like to personally extend a special welcome to my fellow Utahans, Mr. Scott Betts. Scott and his company have done excellent work for many years helping Utahans save for retirement. I am especially grateful that you would travel all the way from Utah to be here today to help us make this a useful hearing. So thank you, Scott, for being here.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Hatch.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. I think you are very right to stress, number one, the bipartisan tradition in this committee for focusing on these kinds of savings incentives, particularly to create opportunity for folks in the middle class. I look forward to pursuing that with you in an approach that is really fact-driven. That is why we asked the Government Accountability Office to help us get an assessment of the most recent developments in savings.

At that point, I think one way or the other, whatever the bills are called, you and I are going to be able to lead the committee in a bipartisan way. I look forward to pursuing that.

Now, we have six witnesses. We have a very talented journalist, Ms. Ellen Schultz, who is still battling Amtrak delays. So we are hoping that she will be with us.

John Bogle has figured, as usual, a way to navigate through that, and so we are glad that he is here. He is, of course, the founder and former CEO of Vanguard.

Our next witness will be Dr. Brian Reid, chief economist, the Investment Company Institute.

Our third witness will be Mr. Scott Betts, who is the senior vice president of National Benefit Services.

Our fourth witness will be Dr. Brigitte Madrian, the Aetna professor of public policy and corporate management at the John F. Kennedy School of Government at Harvard. She was, I believe, the first academic to do research on automatic enrollment in 401(k) plans. I know a number of our colleagues are interested in discussing that.

Our fifth witness is Dr. Andrew Biggs, a resident scholar at the American Enterprise Institute. He also lives in Oregon. I told Senator Stabenow that I was wearing my Ducks tie today, and I did not wear it for 2 weeks out of respect to Senator Stabenow and the State of Michigan after the Ducks triumphed over Michigan State, but, Dr. Biggs, I could not hold off any longer.

Senator STABENOW. There will be another day.

The CHAIRMAN. There will be another day.

Senator HATCH. I am glad the fight is between two Democrats this time. [Laughter.]

The CHAIRMAN. We will await Ms. Schultz. Mr. Bogle, welcome, and we look forward to your presentation.

Senator Brown has a very tight schedule this morning, so, when all of you are done, Senator Brown will begin the questioning for our side, and then we will turn to Senator Hatch.

Mr. Bogle?

**STATEMENT OF JOHN C. BOGLE, FOUNDER AND FORMER CEO,
THE VANGUARD GROUP, INC., VALLEY FORGE, PA**

Mr. BOGLE. Good morning, Chairman Wyden, Ranking Member Hatch, and other members of the committee. I am honored by your invitation to be with you.

My career in the financial services field began more than 63 years ago—a long time. In 1974, I founded the Vanguard Group, a new company on the mutual fund scene, and we now manage \$3 trillion worth of other people's money and have become the largest mutual fund firm in the world.

The principal reason for that success—and success is a fair description—is that, since 2008, this single firm has accounted for almost one-half of the mutual fund industry's entire cash flow. It is simple. We were founded with a single focus: to serve mutual fund investors.

Our management company—and this is important—the Vanguard Group, is owned not by its managers, nor by the public, nor by a U.S. or foreign insurance company or financial conglomerate—today, unfortunately, the industry's most prevalent corporate structure. We are owned by our mutual funds, which in turn are owned

by our 20 million mutual fund shareholders. We are uniquely a mutual mutual fund complex.

We operate the funds on an at-cost basis. The substantial profits we might otherwise make, which came to \$19 billion in 2013 alone, were, in effect, rebated to our shareholders in the form of lower costs.

I am also the founder of the world's first index mutual fund, the Vanguard 500 Index Portfolio. As you all know, the index fund simply mimics the portfolio or particular index of prices of stocks or bonds. Largely because it pays no investment advisory fee—because it does not require any advice—it carries a rock-bottom expense ratio, as low as 0.02 percent or 0.05 percent. That is what we call 2 to 5 basis points, compared to other fund groups charging maybe 200 basis points.

Index funds have accounted for more than 350 percent of U.S. equity mutual fund net cash flow since 2007, taking in \$750 billion while other managed funds were losing \$550 billion—the picture is pretty clear—and now constitute 33 percent of U.S. equity mutual fund assets. At Vanguard, a trillion dollars more than that is owned by investors building their own retirement nest eggs or retirement plans for corporations large and small, among them employees of State and local governments as well.

Among all defined contribution retirement and thrift plans, we are now the largest provider of mutual fund assets. So we have a huge business stake in assuring our Nation's retirement plans are structurally efficient and fiscally sound. Fund shareholders also have a huge stake in minimizing the management costs of their investment. Outside of Vanguard, those costs are grossly excessive.

Unfortunately, our retirement system today is neither structurally efficient nor fiscally sound. For different reasons, each one of the three legs, as we call them, of our retirement system stool—Social Security, pension plans, and savings plans—is headed for a serious train wreck. Other witnesses seem to assume that Social Security and pension funds are soundly financed. Unequivocally, they are not.

Leg one, Social Security, can be fixed with relatively few small changes from its imperfections today to moderate the growth of benefits and increase contributions.

Leg two, defined benefit plans, now most deeply under water by \$4 trillion or more, will require much more realistic assumptions of future investment returns than the 8 percent they are using—that just is not in the cards—as well as (a) higher employer contributions, and (b) lower employee benefits—tough medicine.

Leg three, defined contribution plans—the largest and fastest-growing component of our retirement system—cry out for structural efficiency and cost reductions. The retirement funds investors accumulate are slashed when DC plans incur vastly excessive costs. Simply, if they invest in low-cost mutual funds, rather than the high-cost actively managed fund, an investor's return—as I show in Exhibit Two, I think it is page 10 of my submission—an investor's long-term wealth could be increased by 65 percent, in that example, from \$561,000 to \$927,000, a \$366,000 advantage, just by taking the cost of the system down to where it ought to be.

We need larger contributions from employees in defined contribution plans. We need to reduce the ability to withdraw savings almost on demand. We need to have some requirement that employers maintain their contributions. We need to expand access to the plan—employee participation—and we need to limit the participation of high-cost purveyors in DC plans and the IRAs.

We also need a Federal standard of fiduciary duty for institutional money managers now, including fund managers, which so far have been virtually ignored by policymakers, regulators, and legislators. I will explain these more fully in my prepared testimony.

Forgive me for going a little bit over my time. Thank you for hearing me out.

The CHAIRMAN. That was very helpful. Thank you. I know we will have questions.

[The prepared statement of Mr. Bogle appears in the appendix.]

The CHAIRMAN. Dr. Reid, you are next.

**STATEMENT OF BRIAN REID, Ph.D., CHIEF ECONOMIST,
INVESTMENT COMPANY INSTITUTE, WASHINGTON, DC**

Dr. REID. Thank you, Chairman Wyden and Ranking Member Hatch, for the opportunity to testify. I am Brian Reid, chief economist of the Investment Company Institute, the world's leading association of regulated funds. ICI's U.S. members manage assets of more than \$17 trillion and serve more than 90 million shareholders.

The point of today's hearing is, mutual funds manage about half of the defined contribution plan and the individual retirement account assets. ICI has devoted years of research and considerable resources to making and communicating an accurate assessment of America's retirement system.

Today such an assessment must recognize three key facts. First, America's retirement system is working to build retirement security for the majority of Americans. Second, the tax incentives for retirement saving based in deferral of taxes, not in tax exclusion or tax deduction, are key to the successes and strengths of that system. Third, while there are opportunities to improve our retirement system, changes should build upon our current structure and not put today's retirement system at risk.

Those statements may contradict much of what you often hear, so let me explain. Not only does Social Security cover nearly all working Americans, but 80 percent of near-retiring households in 2013 had accrued pension benefits. And a wide range of government, academic, and industry research demonstrates that the American retirement system has become stronger in the past half-century.

The poverty rate among the elderly has fallen since 1966 from nearly 30 percent to 9 percent, the lowest among all age groups. Since 1975, the amount of assets that is earmarked for retirement per household in the United States has increased sevenfold after adjusting for inflation. The share of retirees receiving private-sector pension income has increased by more than 60 percent, and the median private-sector income that retirees receive after adjusting for inflation has increased by 40 percent. These statistics speak to the impact of Congress's bipartisan efforts that transformed So-

cial Security into a strong foundation for America's retirement system and created a framework of laws and tax incentives on which voluntary private employer plans and IRAs have grown and thrived.

As important as the tax incentives are in encouraging employers to offer plans and employees to participate in them, the nature and role of these incentives is often misunderstood. The tax incentives take the form of tax deferrals, because contributions and earnings to traditional retirement plans are taxed when a retiree withdraws the income.

This is fundamentally different from a tax deduction or exclusion where the initial tax reduction is never recovered. In economic terms, it is the after-tax rate of return that is incentive to save. Tax deferral effectively taxes investment income at a zero tax rate for retirement savers in all income groups. Thus, rather than creating a so-called upside-down incentive for saving, tax deferral equalizes the incentive to save across all retirement savers in all income groups and encourages support for employer-sponsored pension plans among a wide range of workers.

The American people overwhelmingly support today's defined contribution retirement plans, including the tax incentives. In a fall 2013 survey, 86 percent disagreed with the idea of eliminating the tax advantages of defined contribution plans, and 83 percent opposed any reduction in employee contribution limits.

Now, despite the strengths and successes of our system, it can be improved, but changes to the current system should build upon the existing system, not put it at risk. ICI supports measures to promote retirement savings, put Social Security on a sound financial footing as a universal employment-based and progressive plan for all Americans, foster innovation and growth in the voluntary retirement savings system, help smaller employers by offering simpler plan features and easier access to multiple-employer plans, and provide flexible approaches to retirement income.

What is central to these ideas is that they build upon and do not undermine or replace our current retirement system. This system depends critically on the tax incentives Congress has provided for retirement savings. Proposals to reduce the tax benefits of employer-sponsored retirement plans would not merely affect upper-income workers and reduce their desire to participate in such plans, but they also would, undoubtedly, reduce the number of employers that sponsor a retirement plan and deprive workers of all ages and incomes of the many benefits of plan participation.

In short, our retirement system has many strengths and successes, and building upon our strong voluntary system will enhance Americans' retirement security for generations to come.

Thank you, and I look forward to your questions.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Reid appears in the appendix.]

The CHAIRMAN. Our next witness will be Mr. Scott Betts.

**STATEMENT OF SCOTT F. BETTS, SENIOR VICE PRESIDENT,
NATIONAL BENEFIT SERVICES, LLC, WEST JORDAN, UT**

Mr. BETTS. Thank you, Chairman Wyden, Ranking Member Hatch, and members of the Finance Committee, for the opportunity

to talk with you about our private employer-sponsored retirement system. My name is Scott Betts. I am senior vice president of National Benefit Services.

NBS is a fee-for-service third-party administrator specializing in the design and administration of all types of employer-sponsored retirement plans. NBS has more than 225 employees located in West Jordan, UT and supports more than 7,500 retirement and benefit plans in 46 states. Our goal is to give every working American the ability to save for a comfortable retirement.

I have been working with employers on their retirement plans for almost 20 years and can tell you firsthand that qualified retirement plans like 401(k) plans are proving successful for millions of American workers. What I see every day is borne out by some important statistics. Middle-class families represent the overwhelming majority of 401(k) participants, 80 percent of participants in 401(k) plans make less than \$100,000 per year, and 43 percent of participants in these plans make less than \$50,000 per year.

An analysis by the nonpartisan Employee Benefit Research Institute found that over 70 percent of workers earning between \$30,000 and \$50,000 participated in employer-sponsored retirement plans when a plan was available, whereas less than 5 percent of those middle-income earners without access to employer-sponsored plans contributed to an IRA. In other words, workers in this group were 15 times more likely to save for their family's retirement at work than on their own.

If increasing retirement and financial security is the goal, increasing the availability of workplace plans is the way to get there. That is why it is so important that no harm be done to the current structure of tax incentives that motivate employers to voluntarily sponsor and contribute, along with the employees themselves, to those retirement plans.

The tax incentive for retirement savings is unique: a tax deferral, not a permanent write-off. Contributions made this year are not taxed this year. Every dollar not taxed today will be taxed in the future when the individual starts taking withdrawals from retirement savings.

Also, the tax incentive for employer-sponsored plans, unlike exclusions such as the home mortgage interest deduction, comes with nondiscrimination rules and limits to ensure that contributions do not discriminate in favor of more highly compensated employees. The result is a tax incentive that is more progressive than our progressive income tax system. For example, in Chart 3 of my written testimony, you will see that families earning under \$50,000 pay 9 percent of income taxes but receive 27 percent of the benefit of a tax deferral in 401(K) plans.

The good news is that over 60 million working Americans currently benefit from these tax incentives through participation in employer-sponsored retirement plans. The Bureau of Labor Statistics reports that 78 percent of full-time civilian workers had access to retirement benefits at work, and 81 percent of those workers participated in these arrangements.

In spite of these positive numbers, there are still millions of workers who do not have plans available at their workplace. More

can and should be done to encourage and help employers, especially small business owners, to set up and operate these plans in a cost-effective manner so their employees can save for their retirement.

There are some changes that can and should be made to streamline plan operations and eliminate pitfalls and penalties for those employers that already have a plan. Senator Hatch, your SAFE Retirement Act has the right focus and strikes the right balance. For instance, the Starter 401(k) plan proposal would allow business owners—who may be reluctant to commit employer contributions—a way to offer employees a chance to save in their workplace plan.

Another important change proposed by Senator Hatch's bill would allow employers to adopt a qualified retirement plan after the end of the year when the final results of the business for the prior year are available. This common-sense change would literally open the window for more plans to be adopted and more employer dollars to be contributed.

Senator Hatch's bill would also permit small employers to band together in multiple-employer plan arrangements, so-called open MEPs, while providing critical safeguards for adopting employers through creating a new designated MEP service provider.

Finally, Senator Hatch's bill also addresses many of the inefficiencies and traps for the unwary employer that increase costs and can discourage employers from continuing to sponsor a plan.

In conclusion, the current retirement system works well for tens of millions of Americans who have access to it, but we need to do more. The key to continued and expanding success is enacting reforms that will further incent employers to provide a retirement savings vehicle for their employees.

Senator Hatch, your bill is a big step in the right direction toward removing complexities from the system and expanding the availability of workplace plans so more business owners will be able to provide a better retirement plan for American workers.

Thank you, and I would be happy to answer any further questions.

The CHAIRMAN. Mr. Betts, thank you, and thank you for being here.

[The prepared statement of Mr. Betts appears in the appendix.]

The CHAIRMAN. Dr. Madrian?

STATEMENT OF BRIGITTE C. MADRIAN, Ph.D., AETNA PROFESSOR OF PUBLIC POLICY AND CORPORATE MANAGEMENT, JOHN F. KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. MADRIAN. Chairman Wyden, Senator Hatch, and other members of the committee, thank you for the opportunity to speak to you today and share my thoughts on how we can strengthen America's retirement savings system.

Public policy has historically promoted saving for retirement using financial incentives. In the United States, the primary inducement to save is the exemption of retirement savings plan contributions—up to a limit—from taxable income.

The Joint Committee on Taxation places the magnitude of this tax expenditure in 2014 at \$127 billion annually. Lower-income

taxpayers are also eligible for the saver's credit, as a further enticement to save. In addition, public policy encourages employers who sponsor a retirement savings plan to provide their own financial inducements for employees to save, namely the provision of an employer match.

A large body of academic literature has examined the responsiveness of savings to financial incentives. A rather consistent finding from this literature is that the behavioral response to changes in incentives is not particularly large. In a recent paper, I surveyed the academic literature on the impact of one kind of financial incentive, matching, on savings plan participation and contributions. The studies using the most credible empirical methods find strikingly similar results in a variety of different contexts using a variety of different data sources. A matching contribution of 25 percent increases savings plan participation by roughly 5 percentage points. This is a modest effect at best.

Conditional on participating in a savings plan, financial incentives can impact how much individuals save. But this effect does not come from the magnitude of the financial incentive so much as from the fact that at some point the incentive expires. For example, in many 401(k) plans, the employer provides a match, but only up to a certain fraction of pay—say 6 percent. The saver's credit gives eligible low- and moderate-income households a financial incentive to save for retirement, but only for the first \$2,000 contributed to an IRA or workplace savings plan. When financial incentives to save are limited to savings below a certain threshold, this threshold becomes a focal point as individuals decide how much to save. For example, data from 401(k) plans show that savings plan participants overwhelmingly choose contribution rates that are either multiples of 5—5 percent, 10 percent, 15 percent—or the match threshold. This finding suggests that the match threshold may be a much more important parameter in a matching scheme than the match rate.

The relatively small impact of financial incentives on savings plan participation suggests that a failure to save is not primarily the result of inadequate financial incentives. Rather, there are other barriers to saving not addressed by traditional policy solutions. The literature on behavioral economics and savings outcomes points to a myriad of frictions that impede successful savings: procrastination, a lack of financial literacy coupled with the complexity of determining how much to save and how best to invest for retirement, inattention, and the temptation to spend. In many cases, countering these frictions leads to increases in savings plan participation and asset accumulation that surpass the effects of financial incentives.

Before discussing policy alternatives to financial incentives that are informed by behavioral economics, let me note that, from a behavioral economics standpoint, the tax code is particularly ill-suited to generating financial incentives to save.

First, the tax code is complicated. It is difficult for the average taxpayer to even assess the financial incentives he or she faces through the tax code. For example, in a research project that I am working on, my coauthors and I have found that most individuals do not accurately understand the tax implications of saving in a

Roth versus a regular 401(k) or IRA. For low- or moderate-income taxpayers, assessing the incentives of the saver's credit without the help of a tax professional would likely be a daunting task. Indeed, I attempted to do so in preparing these remarks and quickly gave up.

Second, individuals are more responsive to immediate than to delayed financial incentives, but many of the financial incentives to save that operate through the tax code are delayed. The benefits of tax-deferred compounding are delayed, as are the benefits of tax deductions or credits that are not processed through payroll deduction or that do not reduce tax withholding throughout the year. Ironically, what could perhaps be a very effective financial incentive to encourage individuals to enroll in a workplace savings plan—a small but immediate financial reward—is actually not allowed in savings plans under current law.

If financial incentives are not a savings panacea, what is? By far the most effective method to increase savings plan participation is automatic enrollment. The impact of automatic enrollment on participation rates can be sizable and is greatest for groups with the lowest savings rates initially: younger and lower-income workers.

Expanding the reach of automatic enrollment is the most promising policy step we can take to increase the fraction of Americans who are saving for retirement. This means continuing to increase the number of employers with savings plans who use automatic enrollment, increasing the number of employers who offer savings plans, and providing simple savings alternatives for individuals who are self-employed or whose employers do not and are unlikely to ever sponsor a savings plan. Policy initiatives that support these measures include auto-IRA proposals and legislation to facilitate the creation of multiple-employer plans with limited fiduciary liability.

Paradoxically, we have a savings system that, in the absence of automatic enrollment, makes saving complicated while, at the same time, makes it very easy for individuals to tap into their retirement savings before retirement. Another policy response that is needed to encourage retirement wealth accumulation is to reduce the leakage from our retirement savings system.

In conclusion, the lessons from behavioral economics research are clear: if you want individuals to save, make it easy. If you want individuals to save more, make it easy. If you want employers to help their workers save, make it easy. And if you want individuals to spend less, make it hard.

The CHAIRMAN. I got the drift that it was all about easy. [Laughter.]

I just want to make sure everybody understands one point with respect to auto-enrollment—because you have been a leading scholar in this. When you talk about auto-enrollment, you still give the individual the last word? The individual can choose not to enroll, in effect, to opt out?

Dr. MADRIAN. Yes, the individual can choose to opt out.

The CHAIRMAN. All right.

[The prepared statement of Dr. Madrian appears in the appendix.]

The CHAIRMAN. Dr. Biggs?

STATEMENT OF ANDREW G. BIGGS, Ph.D., RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. BIGGS. Thank you. Chairman Wyden, Ranking Member Hatch, and members of the committee, thank you for the opportunity to testify today with regard to retirement saving and security in America.

The word “crisis” is often overused. Generally, this is harmless, but in public policy the perception of a crisis sometimes causes people to leap before they look. This is the case today when it comes to retirement security. One well-known study claims that more than 50 percent of Americans are at risk of insufficient retirement income. Another study claims that 85 percent of Americans are falling short, and the total retirement savings gap may reach \$14 trillion. Yet another study claims that Americans collect only a pittance from their IRA and 401(k) plans.

In response, some are proposing expensive expansions of Social Security benefits. Others are arguing that IRAs and 401(k)s are not working and should, effectively, be scrapped. In fact, these claims are overblown, and the policies being proposed are non-solutions to a non-crisis.

While this kind of analysis is necessarily complex, I might simplify it with two sets of facts. First, the majority of today’s retirees are doing well: 75 percent of current retirees tell pollsters they have enough money to live comfortably. Data on poverty and other measures of retirement security show that most retirees today are able to match their pre-retirement standard of living.

Second, the best research out there—from a model developed by the Social Security Administration’s Office of Policy, using inputs from the best retirement experts in and outside of the government—projects that future generations of retirees will have about the same level of retirement security as today’s retirees. Specifically, SSA projects that, in retirement, the GenXers will have the same replacement rates as individuals born during the Depression, who supposedly enjoyed a golden age of retirement security.

This model from Social Security incorporates some of the same data from the Federal Reserve study that you were referencing earlier, Senator Wyden. The Employee Benefit Research Institute also projects that retirement security for future generations will roughly hold steady with today’s retirees. Put those two facts together and you come to this conclusion: if we do not have a crisis today, it does not appear we will have one in the future. Yes, some Americans are under-prepared for retirement—around 25 percent according to some studies—with relatively modest savings shortfalls among those who are fully insured. But these shortfalls are targeted. For instance, one study finds that single, less-educated women are roughly twice as likely to fall short in retirement as pretty much any other demographic group. So, while we do not need to reinvent the wheel, we do need to do something.

I am fully in favor of auto-enrollment pension plans, but less-educated workers are less likely to be offered pensions on the job. Senator Marco Rubio has a proposal to allow workers who are not offered a pension by their employer the chance to participate in the Federal Thrift Savings Plan. Similarly, others have proposed a so-called “Super Simple” pension. It is designed to reduce administra-

tive and compliance costs for small employers who are least likely to offer pensions.

Senator Wyden, you have referenced today State-based plans to enhance pension offerings for workers who are not offered plans on the job. Senator Hatch, your own legislation has provisions designed to encourage the offering of pensions to low-wage workers who might not otherwise be offered one.

Still, though, this may not be enough. For instance, many single women without a high school education are likely to have only sporadic attachment to the labor force, so personal savings can only go so far for these individuals. At the same time, though, Social Security treats single women far less well than it does married women. So they are not getting much help from that end of things either.

That is one reason that I and others have proposed reforming Social Security to include a flat, universal benefit set at the poverty level that would go to all retirees regardless of income or labor force participation. On top of that, individuals would save in supplemental retirement accounts provided either through their employer or, if not available, through the government.

This approach is qualitatively similar to that of the U.K., Australia, Canada, and New Zealand. In the U.S. context, it could affordably reduce the elderly poverty rate from today's level of roughly 9 percent to approximately zero percent, while increasing real retirement savings among the middle- and high-income workers who truly should be saving more.

The lesson of all of this is that there are no simple problems and no simple solutions, but a small, if more complex, problem is better than a retirement crisis.

Thank you very much.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Biggs appears in the appendix.]

The CHAIRMAN. Senator Brown has a hearing in a few minutes. Let us start with him.

Senator BROWN. Thank you, Mr. Chairman. I know all of my colleagues, as Senator Cardin pointed out too, have busy schedules. I have to chair Banking, and thank you for the special dispensation here.

In 1970, a political scientist named Ben Wattenberg decided to try to find out what person represented America best, who was the prototypical American. He settled on a white woman in Dayton, OH, married to a union machinist—retired—who had a pension plan, a defined benefit pension plan. In those days, her family income was about \$60,000. She was right in the middle. Half of America was poorer than she. Half of America was wealthier than she.

Today, that machinist's wife in Dayton probably would not have a union plan. She certainly would not have a defined pension benefit. She and her husband would probably have less equity in their home. Depending on the estimates, if she is in her mid-50s, she would have savings of somewhere in the vicinity—I know scholars differ on this—of as little as \$11,000. If you look at Fed numbers, she could have up to maybe \$50,000. Take the middle. Whatever

that number is, she will have to rely on Social Security for most of her income when she retires.

In fact, today in my State—Ohio is not much different from other States—the majority of people on Social Security rely on Social Security for more than half of their income. The person in the middle will get no more than \$1,300 or \$1,400 a month. So we know that, for an enormous percentage of American workers—again, she is right in the middle; half are poorer than she is—retirement security is in doubt.

Mr. Bogle, in your testimony, you make a number of important points about adequacy. One very important point is that high-cost funds and too many choices can rob unsophisticated investors, those in the broad middle or slightly lower, of the ability to adequately save. Dr. Madrian said, “Make it easy.”

My question to you, Mr. Bogle, is, should Congress make it mandatory to auto-enroll and auto-escalate into low-cost index funds? Should Congress make it mandatory to auto-enroll and auto-escalate?

Mr. BOGLE. Well, with auto-enroll it is pretty easy to say, why not have it mandated? I, for one, would be the champion for mandating index funds. For heaven’s sake, just look at it this way, Senator: all of the investors in America, all of the retirement plan investors, own the total stock market together. They are a giant index fund, so they can go to an index fund and own that total share of the stock market for 2 to 5 basis points. And, if they want to fight among themselves to see who is best and get managers to try to outguess the others, they are going to get the market return, less 200 basis points.

So, it is mathematically correct, but alas—I probably should not get into this here—it is probably politically undoable. But it should be made a more important qualification for entry into the system.

Senator BROWN. And the auto-escalate?

Mr. BOGLE. Auto-escalate is good.

Senator BROWN. As people’s income goes up, a slightly higher percentage will go into that fund?

Mr. BOGLE. Let me say that these things are right and correct as principles. The fact of the matter is, every family is different. Should you auto-escalate for a man with six children all going to college and a wife who may be ill? In other words, when you go from generalities to particulars, it is a tough—

Senator BROWN. But that, Mr. Bogle, is why you give the option to opt out.

Mr. BOGLE. Yes.

Senator BROWN. You are able to do that. Thank you, Mr. Bogle.

Dr. Madrian, you said you should not already have to be in the middle class to get access to tax-preferenced savings vehicles. They should be designed to help workers get into the middle class. What are the policy changes we need to make to ensure that this happens; for instance, raise the minimum wage, make the saver’s credit refundable—all of the above? What policy changes do we make to give people a lift, to be of some assistance to get into the middle class and get access to these savings vehicles?

Dr. MADRIAN. In my mind, the biggest problem with the current system is that many workers do not have the ability to save for re-

retirement through payroll deduction because their employer is not offering a savings plan or they are not eligible for the savings plan that their employer is offering, so I think we need initiatives to encourage small employers to offer a savings plan.

The small employer is a lot like the individual investor. Joe from Joe's Pizza does not have an MBA, does not have a dedicated human resources professional, and is no better at picking a savings plan for his employees than his employees are at picking from 8,000 mutual funds what the best way to save for retirement is. Having an option that is easy for Joe's Pizza to opt into, and other employers like Joe, would help close the access gap.

So we should allow communities to have the chamber of commerce sponsor a multiple-employer pension plan where Joe does not have to worry about the fiduciary liability of picking the right or wrong investment options, and the employees who are in the same workforce in a locality have a similar benefit plan—they can talk about it, they can learn about it. Things like that would go a long way towards closing the access gap.

We should provide incentives for companies to open their savings plans to all employees. In some companies, part-time workers are excluded. These are simple measures that could go a long way.

Another point that I brought up in my testimony is, current law right now does not allow for companies to give a small financial incentive to sign up for the savings plan in the first place. So if you did not have automatic enrollment, or even if you did, to encourage employees to opt in rather than opt out, you could not, for example, say, sign up before the end of the month and you will get a \$50 Amazon gift card, or, sign up by the end of the month and we will enter you in a drawing for an iPad. Things that banks have used in the past to get people to sign up for a savings account, that phone companies have used to get employees to sign up for a cell phone plan, those are not allowed under current law, even though the literature on employee behavior suggests that small immediate financial rewards are, in fact, very effective types of incentives.

The CHAIRMAN. We are going to have to move on at this point.

Senator BROWN. Thank you.

The CHAIRMAN. Thank you, Senator Brown.

Senator Hatch?

Senator HATCH. Well, thank you, Mr. Chairman. I would just as soon you go ahead of me.

The CHAIRMAN. No, please.

Senator HATCH. All right. Mr. Betts, you have real-life experience trying to convince small employers to adopt a retirement plan for their workers. Can you explain further: (1) what are their motivations when they make a decision to offer a plan, and (2) what sort of things convince them to say "no" to setting up a new plan?

Mr. BETTS. Thank you, Senator Hatch, for the question. Working with employers for many years, it has been the incentives that the government has included in these plans that have incentivized employers to set them up. These incentives have motivated the employers to provide this retirement plan for their employees, so the effect of the incentive is very powerful.

Now, many employers like to do it because it is the right thing. Today many job-seeking employees seek employers that have a re-

irement plan. They will ask, do you have a 401(k) plan for me? But that incentive is the key piece. If that were changed or removed, many employers would end those plans.

Also, the incentive is what allows new employers to start plans and get benefits in place in these plans. So I think the power of it is there and is demonstrated in the numbers of Americans who are saving today.

Senator HATCH. Thank you. Dr. Betts, and, Dr. Reid, maybe too, the end result of many of the proposals I read about would be to effectively cap employee deferrals. All of these proposals seem to rely on the premise of lower contribution limits for workers who increase their savings rate. The proposals also assume that reduced tax incentives for companies will have no effect on the willingness of the business to keep its plan in operation or even to start a new plan.

Well, I do not believe that. I think if we roll back the laws Congress has enacted that raised contribution levels and increased tax incentives to save, then two very bad things would happen at a minimum. First, businesses would stop contributing to pension plans because they are too complex and expensive to put up without adequate tax incentives. Secondly, employees would stop saving so much because the tax incentives would be less for most workers. I do not think academics, generally, understand either of these points.

Now, Mr. Betts, what does your real-world experience working with business people making these decisions tell you? After you finish maybe, Dr. Reid, you might care to comment.

Mr. BETTS. The tax incentive is very powerful in middle-class America in making these decisions. The tax incentive to contribute is very motivational. Now, I agree with a lot of the auto-enrollment abilities—that has added to the number of Americans participating—but it is really that incentive that motivates people to enter those plans.

Senator HATCH. All right. Dr. Reid?

Dr. REID. Senator Hatch, I think there are two points that I would like to make here. The first point is about the tax incentives and what is the incentive to save. This is really the key question. So, as you know, the current system for retirement savers is that we defer our taxes. So, when we make a contribution, we do not pay income taxes on the money that we put in or the earnings as they build up. But when we take money out of these traditional retirement plans, a 401(k) or an IRA, we pay the income tax when it comes out. It is, therefore, a deferral, not a deduction or exclusion.

What this deferral does is, effectively, it gives a zero tax rate on the investment income in that plan. And that is the incentive. It removes the tax wedge and allows the return for the investor to come up to the point of the market return as opposed to a below-market return after the tax.

Why is that important? Some of these proposals to cap the up-front deduction would actually turn the tax incentive on its head. So one example is, for instance, to cap the up-front deduction at 28 percent and give you a credit. So anyone in an income tax level above 28 percent, let us say 35 percent, would have to pay a tax

going into the plan, and then they would pay their full tax rate coming out of the plan.

What this, effectively, would do is disincentivize someone who is putting money into that plan in that upper-income level, and actually make it almost preferential to put money into a taxable account. They would have to hold the money in that retirement plan for 13 years to catch up from that extra tax hit at the beginning.

So I think these proposals to cap the deduction, make it a credit, and put a tax penalty on higher-income savers would be very detrimental for higher-income savers. Many of them would be better to pull out.

The second point is that the contribution limits are really important. And one reason those contribution levels are currently important is because people's ability and willingness to save for retirement changes over their lifetimes. So we find individuals, as they move into their 50s and 60s, are more likely to participate and contribute at the limit. Fifteen percent of people in their 50s and 60s are contributing at the contribution limits.

Senator HATCH. Well, thank you.

Mr. Chairman, if I—

The CHAIRMAN. Senator Hatch, please go ahead.

Senator HATCH. If I could just ask a question of Dr. Madrian—Doctor, while behavioral economics has shown a couple of successes, some of us are concerned that the field contains some who, rather than providing a nudge to, perhaps, help people navigate difficult decision-making, would provide full-fledged open field tackles of private citizens. It seems as though some behaviorists operate from a notion that academic and government technocrats are infallible and need to tell fallible private citizens of their mistakes and how they should lead their lives and allocate their resources.

As an example, a former Treasury official in the Obama administration, along with a Harvard professor, has written about “behaviorally informed financial services regulation.” One of their proposed schemes is to nationalize all late fees on credit cards, give card issuers a small amount determined to be fair by some government technocrat, and use the nationalized pool of funds for financial education and other ways to help fallible private citizens.

Dr. Madrian, how do you feel about such a proposal, and do you believe that infallible government technocrats need to, effectively, make decisions for private citizens on credit cards, or on retirement savings, under the notion that those citizens are not doing what the technocrats want them to do?

Dr. MADRIAN. So, I will have to confess that I was not prepared to answer that question when I walked into the room. I know whom you are talking about, and I have read the article that you refer to more than once.

I guess I would say—

Senator HATCH. Take a swing at it. [Laughter.]

Dr. MADRIAN. How about if I answer a slightly different question?

Senator HATCH. That would be fine.

Dr. MADRIAN. I guess my view of behavioral economics is that what it does is try to expand the scope of understanding of what is actually driving behavior and what are the tools that you could

use to influence behavior. Whether you want to take a light-handed approach or a heavy-handed approach, that is a matter of personal preference. So I disagree with painting all behavioral economists with the same brush. I think you are going to find people along an entire spectrum, but I would be happy to go back and look at that article and send you a response to your questions——

Senator HATCH. I would like to have that.

Dr. MADRIAN [continuing]. When I have had more time to think about it.

Senator HATCH. I would like to have that.

Mr. Chairman, I have to leave, but I just want to mention that this is an excellent panel. I have questions for each one of you. I apologize that we have run out of time, but forgive me for having to leave at this point.

The CHAIRMAN. Well, thank you, Senator Hatch. As you and I have talked about in the past, this is going to be a focus of bipartisan tax reform. Thank you very much. I look forward to working with you.

Senator HATCH. Vice versa.

The CHAIRMAN. Senator Stabenow?

Senator STABENOW. Thank you very much, Mr. Chairman, to you and our distinguished ranking member. This is a very, very important issue, and I appreciate the focus now and look forward to working with you.

Let me just start by saying that I am a little surprised at what feels like an optimistic view that most people are saving and somehow people are going to have enough, and they are doing well. I would just throw out a couple of different numbers. Boston College Center for Retirement Research said in 2010 that we would have at least a \$6.6-trillion deficit in terms of what people needed and what they were saving. Last year, 2013, the National Institute on Retirement Security said that 92 percent of working households did not meet the targets they needed for savings, somewhere between \$6.8 trillion and \$14 trillion.

So I am concerned about the differences there, but I want to ask specifically about a group of folks I think we have not talked about this morning. As we look at what happened in the Great Recession with people losing their jobs and their homes—and they lost the equity in their homes, which was a major way that people saved, middle-class families, for retirement—and we look at what has happened to so many folks, we know that a lot of people took hardship withdrawals from their retirement accounts. We are told that they increased as much as 40 percent. So folks were saving, and then they had to take a hardship withdrawal because of what was happening to them, on top of losing the equity in their home. So, I am very concerned about folks who are now in a deficit position, who were doing the right thing and were caught up short because of something that happened that was way beyond their control in all of this.

Mr. Bogle, I would ask you first: are there options that you would suggest to us that would help these workers rebuild a secure retirement who got put behind the eight ball because of the recession?

Mr. BOGLE. Well, that is not an easy problem to solve, Senator, to say the least.

Senator STABENOW. Right.

Mr. BOGLE. I do think that we have to face up—as we look at our whole retirement system—to the fact that, according to the ICI, 33 percent of our population households have no retirement plans at all. The Federal Reserve says—and a very reliable source they are—only about a quarter of our households are preparing for retirement.

I look at those kinds of data as more important than all of the tail data you see about how many dollars are here and how many dollars are there. Here is a case where I think common sense and the superficial data should override the complex data which concludes, as you now have all found out, just about any answer you want.

So how to help somebody who is in real trouble is not easy. We should face the fact that the lower quintile of American income is \$20,000 a year before taxes, unchanged on a real basis, cost of living adjusted, since 1979. And those people are not able to save. If we want to help them, there is simply no recourse than to increase benefits at the lower end of Social Security. It is complex, but the money has to come from somewhere. And that would be, I think, the best answer I can give to your question. We have to look elsewhere than the private retirement system.

Senator STABENOW. Well, to add to that—and I would ask each of you if you could briefly respond—right now it is costing us about \$800 billion over the next 5 years alone as we look at retirement account pension contributions. I certainly support this as a major area where we are focusing tax policy, but we also do know that, according to the CBO, the top 20 percent of households receive nearly twice as much of the tax benefits for retirement savings as the bottom 80 percent combined. Now we understand why that is, but the problem is, as we are looking at tax reform, the households that need the least help in saving for retirement are getting the biggest help, and the people who need the most are getting the least help.

How would you suggest, or would you suggest that we do anything to improve the targeting of the tax incentives for retirement? Also, if anybody has a thought on how we could help the folks who got put in a hole here in the recession, we would appreciate that.

Mr. BOGLE. Well first, looking at the high end of that, this is something—I will actually stand in for Ellen Schultz, because I read her book.

Senator STABENOW. So did I. Yes.

Mr. BOGLE. People at the high end of the income scale have so many retirement plans, such as deferred compensation, reimbursements for taxes paid, things that are in my opinion socially outrageous—if you can handle an opinion that strong—and get all kinds of benefits that are above and beyond what we can do and what we even think about in our retirement system. I would say that was the place to begin reform, and if those savings from making retirement so easy for our wealthiest citizens can somehow be transferred to those lower on the income scale, I think that would be desirable. But, alas, I cannot tell you how to do it today.

Senator STABENOW. Well, thank you very much. I will ask everybody briefly, but, Dr. Reid?

Dr. REID. Senator, I think there are a couple of things at issue here. The first is that, if you think about the entire retirement system, putting employer plans together with Social Security, it still is a progressive system. And it really is the combination of those two that creates joint incentives to save.

The second point is—and I think this is where we have provided some caution—there will be consequences if you begin to scale back contribution limits. Really, right now, the contribution limits are pretty modest relative to where they were historically, when ERISA was first set up, and individuals who take advantage of them tend to be in their peak earning years. If you begin to carve that back or begin to tinker with how those tax incentives are created, you could have higher-income employees not interested in participating anymore. Employers may then decide that it is just better to give them current compensation and not offer a retirement plan, and we could actually end up reducing overall participation.

I think an example of that is, in 1986 we removed the ability of high-income workers to participate in an IRA. The following year, not only did high-income workers no longer participate in IRAs, but even low-income workers stopped participating in IRAs. And it is complex why that happened, but I think it is a cautionary tale.

The CHAIRMAN. Senator Stabenow is asking a very good question. If you all can give short answers, that would be good.

Senator STABENOW. I guess what I would say, in the interest of time, Mr. Chairman, is, does anybody think we ought to target incentives, and if so, how?

Mr. BETTS. I would increase incentives or remove the disincentives out of these retirement plans that can be put in by employers so that we can expand the access.

Senator STABENOW. And you would do that for everyone?

Mr. BETTS. There are disincentives already built into the system that make it difficult for the small employer to start these plans. Senator Hatch's bill has a number of things that remove some of those disincentives and make it easier for small employers to start a plan so more Americans could be saving.

Senator STABENOW. Thank you.

Dr. MADRIAN. If you were worried about low-income and vulnerable taxpayers, another characteristic that would describe many of those individuals is, they are not particularly financially literate. You can create all sorts of complicated tax incentives, and you are not going to get a lot of traction, because the tax incentives are not solving the problem. The reason those households are not saving is not because they are facing small tax incentives, it is because they do not know what to do or their employers do not offer a plan.

So, a far more sensible margin for spending public dollars would be to create the incentives for employers to offer savings plans and automatically enroll their low-income workers, because that solves the problem of inaction and individuals not really knowing what to do.

The CHAIRMAN. Is there anything you would like to add, Dr. Reid?

Dr. REID. I would just briefly reiterate a point from my testimony, which is that folks who end up in retirement without a lot of savings, without a lot of wealth, are often people with very sporadic attachment to the labor force during their working years. These are folks for whom employer-based savings plans are not going to do very much. But they are also folks who often fall through the safety net—Social Security. Social Security serves a lot of these folks not particularly well, because it is an earnings-based program, and because it has very odd distributions of benefits even among low-income people.

So I think we do need some rethinking of who is falling short. What do we need to do for them? For some it is more individual—

The CHAIRMAN. That is important. I am going to have to stop you at this point.

Senator STABENOW. Thank you.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. I am going to start with Mr. Betts. In your testimony, you state that our current tax savings system is “more progressive than our progressive income tax.” Now that is an important point from my standpoint, because critics of current savings incentives frequently argue just the opposite. So I am going to give you a chance to elaborate on how the current savings incentives are actually progressive.

Mr. BETTS. Thank you, Senator Grassley. Yes, in my testimony I provide a chart that demonstrates that Americans who earn less than \$100,000 basically represent 28 percent of the tax collection. But the same group of Americans receives 49 percent of the benefit through the employer-sponsored retirement plans. That seems quite a bit more progressive.

In addition, what is not noted in that is the many employers that actually provide employer contributions into these plans because of the way they are designed. The nondiscrimination rules and opportunities and incentives for employers permit them to put in more employer dollars that are not even covered in this chart.

Senator GRASSLEY. All right. For Dr. Reid: as you know, there are currently several proposals that would limit the ability of upper-income individuals to deduct retirement contributions. That 28 percent limitation is an example.

Now you discussed this with Senator Hatch from the employee standpoint. I would ask you: how does your research suggest employers offering defined contribution plans would respond to proposals such as the President’s?

Dr. REID. So, it is important to keep in mind, Senator, that a 401(k) plan is an employee benefit. It is something that, when an employer is looking to attract employees, they know that to attract high-quality employees, they want to offer this benefit like they would any other benefit.

If you have something in place that makes participating in that defined contribution plan unattractive for a group of potential or existing employees, the employer is going to say, well, I am going to use my resources elsewhere. I may just simply increase wages or something else and not offer a plan.

The example that I gave was, by putting a cap or a credit in place, what will happen is that certain individuals, employees, will have to pay a tax going into the 401(k), and then they would have to pay the full tax rate coming out. Actually then, for some of these employees, they would be better off simply putting their savings in a taxable account outside of their employer's plan.

The employer then, if that begins to happen, is going to say, well, this is not a benefit that a substantial number of my employees want. I am just not going to offer that anymore. I think, as many of the other panelists have pointed out, the benefit is having that employer plan there and in place. And being able to, in many cases, auto-enroll people actually increases participation.

I think, with the President's proposals, we would be taking significant steps backwards from the actions that Congress has taken over the last 50 years, and we would actually potentially reduce plan participation.

Senator GRASSLEY. I am going to go back to Mr. Betts. Employer-sponsored retirement plans are an important component of any retirement plan. While 80 percent of the full-time workers have access to a retirement plan, this number is only around 50 percent for employees working for small employers with fewer than 100 workers.

Mr. Betts, as someone who worked with businesses in the administration of their retirement plans, what do you see as the biggest barrier to employers, particularly small employers, offering retirement plans? Probably a more important question would be the second one, so spend more time on this: what single reform, if implemented, do you believe would do the most to increase the number of small businesses offering retirement plans?

Mr. BETTS. Thank you. Yes, there are several older rules in the nondiscrimination rules that were put in place early on in these plans. Newer rules have done better at managing the nondiscrimination requirements in these plans. One of the ones that could be removed would be the top-heavy requirement. That has disincentivized many small employers from starting a plan because of the risk of how much employer money they may have to put into a plan to satisfy that rule.

Another big step in the right direction would be Senator Hatch's Starter 401(k), being able to provide an employer plan so employees can start contributing where there is no risk of an employer contribution until such time as that an employer becomes financially stable and can benefit from a larger plan.

Senator GRASSLEY. All right. My last question would be both to Dr. Biggs and Dr. Reid. What are your thoughts on the reform proposals, such as Chairman Camp's, that would generally push more retirement savings into Roth-style 401(k)s and IRAs? Should Congress consider consolidating the types of retirement accounts in order to reduce confusion for savers, or is it important for individuals to have more options?

Dr. REID. Senator, I think we are always in favor of simplification. I think one of the concerns that we would have in terms of potential consolidation is that, unlike some of the proposals like Senator Hatch's and others that are trying to find ways to make it simpler for small employers to offer a plan, consolidation could

actually then narrow the options, making it more difficult for small employers to offer a plan. So that is why we have been in favor of concepts such as Starter 401(k), to enhance and broaden the scope of employer offerings of retirement plans.

Senator GRASSLEY. Mr. Betts, do you have anything to add?

Mr. BETTS. No, thank you.

Senator GRASSLEY. All right. I am done, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley.

Senator Cardin?

Senator CARDIN. Mr. Chairman, first of all, thank you for holding this hearing. I agree this is a critically important issue. It has been 15 years since then-Congressman Portman and I recognized that we had a significant problem in our economy. Fifteen years ago, our economy was growing, and our workforce was growing, and income was growing. We led the world in just about every economic indicator, positive, except one. That was savings. Our savings ratios were, in fact, negative during some of those years.

We also recognized that Americans did not have enough money for retirement, particularly lower-wage workers and younger workers. So we tried to do something about it. We were able to get several significant provisions incorporated into our tax code. I want to build on that.

Our first principle was to try to simplify and to increase the limits, particularly the catch-up contributions, because of the point that some of you have raised that, when you are young, you have family, you have homes, you have all of these issues, including education expenses, and you do not think about retirement until later in life. Then the limits prevent you from building up enough in order to provide for retirement security.

Our purpose is pretty simple, and that is what all of you have mentioned: access to retirement plans. If an employer does not offer a plan, there is going to be limited access. If you simplify, and if the limits are high enough to make it worthwhile, more employers will provide plans. That has been the result of legislation allowing for higher limits and more simplified plans.

We also recognize that when employers put money on the table, more people will participate. Look at the Federal Government, the Federal Thrift Savings Plan. Our workers participate in it. Why? Because they do not want to leave money on the table. So, when an employer sets up a plan and provides matching contributions, it is much more likely that workers will participate. That is one of the things that we try to encourage.

The alternative to that is to try to put some money on the table through the government, because, as important as the tax deferral benefit in employer-provided plans is, it is not enough for lower-wage workers and younger workers to participate at the levels we would like them to. So the saver's credit was the substitute, and the saver's credit has worked. Millions of Americans today are using the saver's credit.

So we have been able to get more participation. Automatic enrollment is important for getting people to enroll, Mr. Chairman, but also the default investment option is more sensitive to the person's age, which means there are better investments made for them, rather than them making decisions themselves.

Lastly, you have mentioned financial literacy and investment advice. All of that was a part of what we tried to do over a decade ago. As a result, we have made progress. More people have retirement plans than would have had retirement plans. More money is in retirement options.

As you know, we have gone through a recession. During a recession, you try to encourage people to spend, not save. As a result, we have lost ground. There is no question about it. We have to do a lot more. We have been on the defense for the last 4 or 5 years in this Congress trying to preserve the options we currently have. That has been our strategy. It is time for us to have a strategy to move forward. That is why I am particularly pleased about this hearing.

How can we build on what has worked, and how can we deal with the issues that many of you have talked about with low-wage workers, the younger workers, not putting enough away for retirement? Mr. Chairman, there are some easy things we can do.

Senator Portman and I have introduced legislation called the Church Plan Clarification Act. It deals with the practical problems that church plans have with ERISA. We should pass that. It is another easy thing we can do. We also have the DB-DC freeze legislation that addresses problems that arise when companies move from defined benefit plans to defined contribution plans. They are trying to do what is right for employees who are in the defined benefit plan by preserving those options, but the nondiscrimination testing rules can be very challenging. Our bill addresses that.

I would hope these modest changes could be done quickly, because they are affecting retirement options today, and we should not wait for comprehensive reform when we can get some progress made. We should move forward and improve the saver's credit. We should improve the automatic enrollment process. We should continue to try to simplify.

I would like to ask—let me start with Dr. Reid—a question. One of the things that has frustrated me is that, when we designed these plans, we made it too easy, in my view, for people to take retirement money for things other than retirement. We also made it easier for them to take lump sums out rather than taking out lifetime income. One of our objectives is to have retirement security, to have an income source that takes the pressure off of Social Security, which was never intended to be the sole source of income for people who are retired.

So what can we do to encourage more lifetime income options for retirement funds rather than having money taken out too early either through a lump-sum distribution or for other purposes?

Dr. REID. So I think with the current system, certainly if you look at what people do within their 401(k)s or IRAs, we find that the vast majority of the money that is in 401(k)s is rolled over to IRAs. We also find that individuals tend to start tapping the money, actually, at age 70½. It is the minority of individuals who do not.

I think that ideas to help individuals to spread out those savings over their lifetime are valuable. I think our concern is driving tax incentives to a particular product. For many low- and moderate-income households, they are already heavily annuitized through

Social Security. They may have that lump-sum nest egg then for emergency purposes or for healthcare needs or something like that. We would not want to penalize these individuals for wanting to keep a lump sum to be able to tap.

Other types of proposals to help people spread that savings over time and to draw on it, I think would be valuable. We just want to make sure that these are product-neutral approaches.

Senator CARDIN. One of the proposals is to give an exemption for a certain amount of retirement funds from the minimum required distribution for the purposes you just said: so that you can keep a nest egg. One of the concerns that we have is that people just take money out when they should not, and we want to provide incentives—and not any one product—but incentives for income flows that can help people avoid outliving their income, which happens too frequently.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Cardin, and I also want to be clear that I am very interested in working with you and Senator Portman on the Church Plan Clarification Act. For those who are following this, this important legislation does what it sounds like. Church plans or retirement plans of churches, they generally are not subject to ERISA, and so we have a situation where we would have to preempt State law so that you could add these auto-enrollment features that are so popular.

I want you to know that we have a score request pending. We are going to work very closely with you. I think it is a sensible suggestion. I do not think it is going to score a lot.

Senator CARDIN. Thank you, Mr. Chairman. I appreciate that.

The CHAIRMAN. Thank you.

Senator Casey?

Senator CASEY. Mr. Chairman, thank you very much for the hearing. I want to thank our panel for your presence today and your work on these issues.

I will start with Mr. Bogle, not only because of his Pennsylvania residence and his impact in our State and our country, but we are grateful you are here, sir. Thank you very much.

Mr. BOGLE. Thank you, Senator.

Senator CASEY. I want to ask you about this, the basic dynamic that has played out over a number of decades now: the shift from defined benefit plans to defined contribution plans and the implications of that. As you noted, there has been a transfer of trillions of dollars in savings and risk to individual investors and away from corporations.

Give me a sense, if you can—as we try to design policy around the questions of giving those individual investors the tools they need to deal with that basic change, the question of educating investors—what more can we do? What model works in terms of giving them, at least, the opportunity to become better educated?

Mr. BOGLE. Well, to begin with, what we have to do is take what was designed as the 401(k) was, for example—it was designed as a thrift plan system—and turn it into a retirement plan system. If you could just think that one through, you would get very close to where you want to be.

In terms of greater utility and greater efficiency for investors, there is just no question in my mind that their investment returns will be improved if they get the cost, the dickens, out of the system. Owning an index fund—let us call it owning the stock market, Senator—is such an easy thing to conceptualize as compared to picking the right manager here and picking the right manager there and, when he does not do well or she does not do well, picking another manager. We find that, for investors in mutual funds—I think this is in my testimony—because of that confusion, the idea that you can pick a good manager for a lifetime of investing simply does not work.

So investors lose another 2 percent. They have a cost built into our system, about 2 percent a year, a staggering number. Making the wrong fund choices is another 2 percent a year, 4 percent a year, that they lag by. So I think if we would simplify the system and at the same time take the cost out of it, investors would have a lot of the mystery removed and be much more willing to sign up for a plan.

Senator CASEY. Is there any experience, based upon your work or based upon the work of Vanguard, as to the age at which or the period of time within an individual's life where this education could be especially significant? In other words, is it starting earlier? I know we have had legislative attempts to make sure that even students at a very young age are exposed to it. Is there any strategy that Vanguard has or has been successful with?

Mr. BOGLE. Well, to give you my own impression, first, the way we now introduce young people to investing is to have stock-picking contests. That is sending exactly the wrong message to them.

We should start with a compound interest table and show them how a percentage point of difference in return mounts up over a lifetime to an astonishing, absolutely astonishing amount. When you get to a higher level of age, I do not think there is a single—well, very, very few, maybe, to be fair—business school or finance school professor who would not tell you exactly what I am telling you: it is an inefficient system that is ill-serving mutual fund investors.

I have in my prepared testimony a statement that is far stronger than that about the inadequacies of the mutual fund system, given by David Swensen, who manages the Yale Endowment with such success and is a person of impeccable integrity. You could easily say I have a vested interest in index funds. I really do not, because anyone can start one, and I would like to have more competition in the index area. It comes down to simplification and owning the market, rather than owning a bunch of different managers, if you are investing for a lifetime.

Senator CASEY. Thank you. I will submit some questions for the record for Mr. Bogle and for others.

In the less than a minute that I have, Dr. Madrian, I wanted to ask you—you made a pointed reference to automatic enrollment and the benefits of that. If you had to look at this purely from the point of view of the tax code, either where we are today or, frankly, where we hope to be, would you have any recommendations for improvements we could make to the code to make it more effective

or, I should say, changes to the tax code to make savings incentives more effective?

Dr. MADRIAN. Yes. I have a one-word answer, and I will spell it out: s-i-m-p-l-e.

Senator CASEY. Simplify, yes.

Dr. MADRIAN. Yes.

Senator CASEY. Mechanically, what is the best way to do that? In other words, when you look at where we are today, the code as it stands today, what change would you hope we would make?

Dr. MADRIAN. That is an excellent question. I think that the tax code overall is very complicated. I think for middle- and higher-income tax payers, the Alternative Minimum Tax and how that interacts with the rest of the tax code makes it a complete mystery. You have no idea what the incentives are that you are facing, or the penalties to do one thing or the other.

On the lower end of the income scale, you then have the interactions between the tax code and all of our social welfare programs. I think very few individuals accurately understand the tax incentives that they are facing. I think the saver's credit, the motivation behind that to give low-income families an incentive to save, is well-intentioned, but if someone with a Ph.D. in economics from MIT cannot sit down and figure it out in 10 minutes, it is too complicated. I think the fact that we have so many different tax-favored ways to save, makes it complicated.

It is not just the retirement system. So, if I am an employee and my employer offers an employee stock purchase plan, a 401(k) plan, and a health savings account, and I have a limited budget for how much I can save, it is very complicated to figure out where I should put that money. Plus we have 529 plans. We have lots of different tax-favored ways to save.

I think some simplification and some consistency across these different plans would be helpful. Why a 403(b) plan has to have different rules than a 401(k) versus an IRA—a lot of it does not make sense to me. I think there are a lot things to do to make things simpler, more straightforward, for both employers offering plans and for individuals trying to decide how to save for health care, for education, for retirement, for a mortgage, things like that.

Senator CASEY. Thanks very much. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Casey.

Senator Portman, I do not know if you were here, but you are already on a roll this morning with your Church Plan Clarification Act legislation to promote auto-enrollment and preempt State law, so just keep going.

Senator PORTMAN. Excellent. Well, thank you. Did our panelists all say they agreed with it and it was going to get enacted into law?

The CHAIRMAN. We are getting a score as quickly as possible. I think it a very constructive idea. I am looking forward to working with you.

Senator PORTMAN. Great. Thank you, Mr. Chairman. I appreciate your interest in this area and having the hearing today. I was here earlier to get to hear some of the great testimony, and what a terrific panel. Thanks for what you are doing.

I know Ben Cardin was here earlier, and, as you know, Ben and I did a lot of work together in the House on these issues, and we have introduced this church plan recently, but also soon we are going to introduce another bill on the whole issue of the non-discrimination testing and the hard freeze and soft freeze issue. This is something we have actually talked to Treasury about in open testimony here, and I think this will be another good clarification plan that will help.

I am excited about what we have been able to do over the years. I think it has made a big difference. I am looking at some statistics right here, some charts on 401(k)s and IRAs, and I know that some are critical of these programs. Here is the reality: even with our tough economic times we have had and during the financial crisis, we have gone from about \$4 to \$5 trillion in assets in 401(k)s and IRAs to about \$10 trillion, over \$10 trillion last year.

So that is not bad, given, again, what happened during 2008, 2009, 2010. We have to just keep it up. We have to figure out how to get more small businesses to provide these plans, and that is the key, to me: encouraging every small business to offer something so that every employee has the opportunity.

As Dr. Madrian just said, keep it simple. We do actually have a simple plan now that came out of the Portman-Cardin work in the House for small businesses. It is actually called "SIMPLE," but there is more work to be done in terms of taking out some of the complication and the cost, and even the liability in it.

The saver's credit, I think, has worked pretty well. We would love to have your views on that going forward, as to how we can make that work better.

On the auto-enrollment issue, when I talk to companies—and I know you all talked about this earlier—we go from about 75 percent participation on average to 95 percent. That is, obviously, a great opportunity. There is more opportunity there, I believe, obviously, to expand that to more companies.

Recently, Senator Warren and I actually introduced a bill that we hope will get hot-lined soon. We would love your support on this bill, which would simply move the default option in the Thrift Savings Plan from being government bonds to a life cycle plan. I do not know what you all think about that, but a life cycle fund, it seems to me, makes a lot more sense for Federal employees. If you are interested in that, now is the week to weigh in.

So I ask you that. What do you all think of that for a default in the Thrift Savings Plan? Maybe Dr. Reid and Dr. Madrian, you could start.

Dr. REID. Well, certainly in the private sector, the defaults that we have put in place in the rules, that Congress put in place around balanced funds and life cycle funds, have been extremely popular. I think that they do help get younger investors into and saving more heavily in the stock market. What we saw is, even while there was talk about younger investors pulling out of the stock market, those life cycle funds did certainly keep individuals who were in 401(k)s contributing.

I think another point here that we would like to make is that, for ways of expansion—going to your broader question—the MEP concept, I think again, for smaller employers, to help them more

easily offer a plan, would be a beneficial change to our system as well.

Senator PORTMAN. Thank you. I agree. Dr. Madrian?

Dr. MADRIAN. Yes. I completely agree with changing the default fund for the TSP. A huge volume of evidence shows that the default fund is extremely persistent under automatic enrollment. So, if the default fund is a bond fund, most of the assets are going to be flowing into the bond fund.

To harken back to Senator Casey's question earlier—how do individuals learn and become more financially literate—the best evidence is that they learn through experience. So, if we want individuals to understand how the stock market works and how diversification works and things like that, having them invested in a life cycle fund which contains a better mix of assets makes a lot of sense.

Senator PORTMAN. There are so many things I would love to talk to this expert panel about, but one is the minimum distribution rules. One idea that is out there that I find intriguing, but would love to hear reviews on, particularly if anybody disagrees, is, should we eliminate minimum distribution rules for plans under a certain amount, say \$100,000? A lot of people who are 70½ are still working, as you know.

I just left the CEO of a major steel company. Unfortunately, they are trying to keep their older workers there because they have a serious skills gap. So what do you all think about that? Who wants to talk about that?

Dr. REID. I think any ways in which we can help to encourage people to spread out their balances over a longer period of time—we certainly find that most people wait and do not withdraw until they hit that age of 70½. Given the fact that life expectancies have increased and that the minimum distribution age has not changed, it certainly merits looking at whether or not that really needs to be adjusted—as long as what we do is product-neutral again. I think, again, what we want to make sure of is that—no matter how you are invested—the minimum distribution age is available to everyone.

Senator PORTMAN. Mr. Bogle?

Mr. BOGLE. I think your conclusion is correct, that there ought to be some exemption for minimum distribution requirements, say \$100,000, that can be taken out without its being required to be taken out. I would also say, on the Thrift Savings Plan, I do think the Thrift Savings Plan needs an option, if you will, where investors can say, I want my money safe for the last 2 years before retirement, let us say. I do not know what the market is going to do, maybe it is going to go down 50 percent all over again. No one knows that, so if that investor really wants protection late in the period before he retires, he should have a highly safe option.

Senator PORTMAN. That, as you know, is the theory with these life cycle funds: you go to fixed income towards the end of the cycle, and I need to look at that more carefully to see if it is the last 2 years.

Let me ask you all a general question, if I might. I am over time already. Thanks, Mr. Chairman, for the indulgence.

There is discussion, as you know, about savings in general and our still-low rate of savings in this country and how it affects the economy. And Senator Cardin and I believe that it does, and I think the chairman does as well. So there is talk about a universal savings vehicle. This came up in the Bush administration. It has come up again recently with some discussion of new ideas about a universal savings vehicle that would be available to everyone.

The analogy has been what they are doing in Canada, for instance, if you followed that at all. It is a Roth-type vehicle therein terms of tax treatment.

What do you all think of that as it would relate to retirement savings? One of the concerns always is, well, if people have the opportunity to save for anything and to pull out for anything, you would have even more leakage. You would have even less assets for retirement. But is that all right because you are increasing savings and financial literacy and banking and so on? Maybe those of you who have not talked yet could just comment on it.

The CHAIRMAN. Quickly, witnesses, so we can get Senator Cantwell in.

Dr. BIGGS. I will pass in the interest of time.

Dr. MADRIAN. I do not know the particulars of the type of proposal you are talking about, but I do know that it would not make sense to have a universal savings plan where you could put money in and take it out for anything unless you have much stronger incentives to encourage accumulation in that plan.

If you are going to let people take the money out for anything, they have to be putting more money in in the first place, if they have to cover everything they are doing. You would need higher limits. You would need financial incentives. You would need every lever out there.

We know from behavioral economics that people engage in a lot of mental accounting in organizing their financial accounts, and one problem with the retirement savings system right now is that we do allow people to take the money out. So it is not clear whether a 401(k) is a retirement plan, or is it a universal savings plan?

Senator PORTMAN. Yes. What penalty, though?

I am sorry, Senator Cantwell. I did not know you had yet to ask questions. I will let you go now, but I just want to say that, if any of you have any thoughts on that, please send them to me, including Dr. Biggs. We may do some follow-up questions as well. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Portman.

Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman, and thank you for this important hearing. I know, according to a New America Foundation study, 92 percent of Americans are not meeting their retirement savings goals. I know that as we look at our budget for Social Security and Medicare, and programs like SNAP, this is going to have an impact on them. So to me, I want to look at ways to encourage more savings and certainly offer more of a lifetime stream of savings.

So, Mr. Betts, I was wondering if you could comment on programs like a lifetime guaranteed annuity product as a way to incent Americans to further save, and a way to help them get more

efficiency out of their dollars. This is something that could be further incented by Congress.

Mr. BETTS. Well, Senator Cantwell, our business is helping employers design, implement, and manage employer-based retirement plans. We do not get into the products that go into them, but we have seen current legislative actions that have introduced opportunities into these plans to have annuity-based structures, things to help better at retirement with these plans.

Our biggest focus, really, is expanding the access so that more dollars are going in. We would like to see less of the disincentives that prevent small employers from starting these plans, so that more Americans can be contributing. As they grow, as these small employers grow, then the employers will put more employer dollars in.

So it is really, from our perspective, getting access and contributing sufficiently. We know at retirement there are a variety of different situations, and people need the flexibility to design the retirement program they need. So the right amount of tools for an American person inside their retirement plan is important.

Senator CANTWELL. Do you like the annuities that businesses are offering? Do you think they are successful?

Mr. BETTS. They have a place for the right person who needs that type of structure, but that is not something we work on in our business.

Senator CANTWELL. Mr. Bogle, do you have any input about annuities?

Mr. BOGLE. The problem with annuities today, like any investments with a fixed-income portfolio, is that the rates are just so terribly low. I have always thought there was a place for an annuity—because it eliminates longevity risk—and a place for bonds. But those returns are so unattractive today that I think investors, and I think their advisors, have to at least vaguely think about whether they are attractive investments.

When you think about a savings plan, a universal savings plan, we really know from history that, because of inflation, putting money into savings over the long term is a loser's game. It probably has a negative return of about 1 percent a year after the cost of living is adjusted.

So I think we have to think differently about short-term investments, and long-term investments. I think annuities have a place, but I think they have to come out of the commercial system and go into more of a public system where the annuitant gets a fair return.

Senator CANTWELL. And how would you do that?

Mr. BOGLE. Well, TIAA-CREF does a pretty good job of it themselves. It has to be an annuity that is run for the investors and not run for the salesmen. It really comes down to that. The costs are horrendous in annuities and life insurance products, if you will forgive my expression. I do not think anybody would disagree with that. If you take the cost out, the rates that you get paid are still going to be low, but for a certain type of investor who wants to assure the longevity risk and has no other assets, I think they are an attractive option if fixed.

Senator CANTWELL. But don't you think, given the crisis that we are facing, that it is important to have that opportunity fixed?

Mr. BOGLE. Yes, we should have that opportunity.

Senator CANTWELL. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Cantwell.

Let me tell you, first of all, this has been very helpful. Obviously, there are a whole host of issues to be examined. It is not a topic for today, but I feel very strongly about getting people to start saving very early in life. That is why we have been talking about child savings accounts. Here again, there are some common-sense approaches you can take.

One of the things that struck me very early on is, when you are talking about people of modest means, their eligibility for various programs can be damaged because somebody sets aside some money, and they set it aside early on. And we may need to waive those kinds of rules so as to start building a savings ethic early.

Today, I think you have to be troubled by where this debate has gone. The Government Accountability Office has told us that well-off taxpayers, more than 9,000 of them, had over \$5 million in their IRA accounts in 2011. We have also seen press reports of executives in the high-tech sector with Roth IRAs with balances over \$30 million and over \$90 million. So you contrast that with what you all have been talking about for the last 2 hours, with the median IRA account balance in 2012 being about \$21,000, and it is pretty clear there is some important work to be done.

So I think what I would like to do, just in terms of wrapping up, is to have you all almost pretend that the roles are reversed here, and you are up on this side of the dais. And Senator Hatch and I, and all of our colleagues, are going to try on a bipartisan basis to encourage retirement saving.

And the way the debate is going to start, when we get to it as part of tax reform, is, right now the American taxpayer is putting up about \$140 billion each year to subsidize retirement savings accounts. This is the second-biggest tax expenditure in the code. You take that and you juxtapose it next to what the Government Accountability Office has told us about those mega-IRAs and the \$21,000 that people have—a median amount in their account—and it is pretty clear this committee is going to have some tough choices to make.

What I would like to do is go down the row and ask each one of you for just one suggestion of where, as part of that effort—with the \$140 billion that is used to assist these accounts—where would you make a change to get a bigger bang for the taxpayer buck? You get to make one choice because that is going to be fairly similar to what the debate will be here in the committee as part of tax reform—making the choice along those lines.

Mr. Bogle?

Mr. BOGLE. Well, the first thing you would obviously do—

The CHAIRMAN. You get one. You do not get a first. [Laughter.]

Mr. BOGLE. All right. Thank you. One thing that we would do is eliminate the larger deductions or have a tax credit instead of a tax deduction, which would impact large investors the most. I would not do that, but that is a choice.

The CHAIRMAN. Very good.

Dr. Reid?

Dr. REID. I would try to expand the system to make sure that more small employers could more easily offer plans, so something like Starter (401)k or MEP.

The CHAIRMAN. All Right.

Mr. BETTS. Similar answer—remove the disincentives and increase the incentives for small employers to start those plans.

The CHAIRMAN. And what is one way you would like to do that?

Mr. BETTS. Starter (401)k and the multiple-employer plan.

The CHAIRMAN. All right.

Dr. Madrian?

Dr. MADRIAN. Well, you do not get to \$5 million in your 401(k) or your IRA by investing up to the limits we currently have and putting it into well-diversified mutual funds. You get there by putting it into employer stock and getting really, really lucky. For every winner with employer stock, there are lots of losers whose companies go bankrupt. So I do not think it makes sense to encourage gambling through the tax code by allowing employers' stock as an investment option in tax-favored savings plans.

The CHAIRMAN. So you would support a change in that area?

Dr. MADRIAN. Yes.

The CHAIRMAN. All right.

Dr. Biggs?

Dr. BIGGS. I would echo the other witnesses' call to simplify plan offerings for smaller employers to get at the low-income workers and improve the incentives for them to offer those plans.

The CHAIRMAN. All right. At this point, we have Senator Nelson on his way. I think what I would like to do is ask our guests, can you all stay a few more minutes?

Mr. BOGLE. Yes.

Dr. REID. Yes.

Mr. BETTS. Yes.

Dr. MADRIAN. Yes.

Dr. BIGGS. Yes.

The CHAIRMAN. All right. What we will do is, when Senator Nelson returns, he will ask his questions, and then the Finance Committee will be adjourned. So we will suspend here for a few minutes, and Senator Nelson will be here to wrap up. Thank you all for your professionalism and for your patience with us on a hectic day.

Poor Ms. Schultz must still be stranded somewhere in Amtrak land.

Mr. BOGLE. I tried to help her.

[Whereupon, at 11:54 a.m., the hearing was recessed, reconvening at 11:55 a.m.]

The CHAIRMAN. Senator Nelson has arrived, and he has had a hectic day. Senator Nelson, it is our plan that you will ask the questions that are important to you and, at that point, you will adjourn the committee. Is that acceptable?

Senator NELSON. All right, Mr. Chairman—and questions that are important to you because you are a member of the Committee on Aging as well.

We had a hearing about the extraordinary debt that is carried by seniors, and would you believe—of all things—student loan debt?

Then, if they cannot pay, lo and behold, their Social Security is garnished, and that brings them below the poverty level, because you can garnish down to \$750, down to that level. And \$750 a month for a senior citizen today is below the poverty level.

The CHAIRMAN. Senator Nelson, you are doing very important work here. I am sorry that I am going to have to go, but the fact that so many seniors have racked up these eye-popping debts that, in effect, are going to color so many of their retirement decisions in the future, is especially important. I look forward to working with you.

Senator NELSON. What I wanted to ask the panel is, what impact does debt have on workers trying to put money aside for retirement. Anyone?

Mr. BOGLE. It puts them in an impossible position. The student loan debt is enormous, selective but enormous. I do not see how you can save beyond that when you are still trying to pay it off, Senator.

Senator NELSON. That is right. Now we recently had somebody talking about our Thrift Savings Plan. The Senate has a very successful Thrift Savings Plan. If you were in a company, they would call it a profit-sharing plan. Here it is called a Thrift Savings Plan.

The question was, propose an idea of opening up a Thrift Savings Plan-type entity to everyone. Do you want to give us any thoughts on the concept?

Yes, sir?

Dr. BIGGS. Senator, I mentioned this in my written testimony. I referenced your colleague from Florida who has advocated this idea.

There are obviously practical issues that need to be overcome, in the sense that the Thrift Savings Plan is a plan for government employees. They have streamlined bookkeeping. So it is in that sense a very easy plan to administer and handle.

I do favor the idea of giving savings options to low-income workers, in particular, who are not offered pensions by their employers. So, whether it is explicitly through the TSP or whether it is through a structure that looks very much like the TSP, I think that is a very good idea. It is an extremely well-run plan. It is simple. It is low-cost. It offers annuities so you can convert your balance into a lifetime income.

So, when you look at the TSP, it answers a lot of the questions we have about retirement security. We can design a good plan. The key is, we just actually have to go out and do it.

Senator NELSON. How would you go about setting up, administratively, a plan like that for anyone who wanted to buy into it?

Dr. BIGGS. The question is, do you have it run through those individuals' employers, where they would not run the plan, but they would deduct the money and send it to the TSP, or do you run it something like an IRA, where the individuals themselves would have to do it? Having their employers do it puts an administrative burden on the employers and may make it less attractive to them, but it is easier for the employee.

If you run it in an IRA setup, the employee makes the decision. That puts no burden on the employers. It is very easy on that end. On the other hand, many employees will fail to do it.

So the question is, how do you make it cheap and easy? The problem for small employers—if you are a large employer who does electronic bookkeeping, electronic wage records, that is a fairly easy thing to do. Your computer does it for you. It is the small employers who are most likely to be writing out the check by hand each month, and the difficulty is, how do you make it work for them?

I think that goes back to one of the points we all made at the end: a key for encouraging retirement savings is making it easier for small employers to offer these sorts of plans.

Mr. BOGLE. Senator, the Thrift Savings Plan is essentially—with all of the long-term money in it, except for the short-term reserves—100 percent index funds. They charge, I believe the number is about 0.025 percent a year, 2.5 basis points for it, which you could argue is even better than the Vanguard 500 Index Fund, which charges a shocking 5 basis points, twice as much. However, the Thrift Savings Plan has their portfolio accounting, the accounting for their participants and beneficiaries, paid in a different source. So they are probably about the same.

I would answer, essentially a Thrift Savings Plan in a different guise is already available to any employer of any size in the Nation.

Dr. REID. Senator, I think, to echo both points, if you would open up the Thrift Savings Plan to potentially millions of employers, you would not have the Thrift Savings Plan anymore, in part because the administrative savings that the TSP gets from one employer with long-tenured employees with very large accounts, those efficiencies would, obviously, go away. As Mr. Bogle says, there are low-cost options within the private sector through mutual funds. You can be in index funds if you choose. You can be in low-cost actively managed funds as well. You can call up any one of the fund companies or a discount broker and open up an IRA or a plan, or a small employer can work with one of them to open up a payroll deduction plan through an IRA as well. So the private market actually does have something that actually is working very well.

Mr. BETTS. I am not able to speak to the TSP, but I can say that—like my colleagues—expanding the accessibility of these savings plans is very important. In fact, I think you have in one of your bills the suggestion to expand multiple-employer plans, which would allow more small employers to offer these retirement plans, savings plans, with some of these types of investments that may be similar to a TSP.

Senator NELSON. Yes, ma'am?

Dr. MADRIAN. I agree with what the other panelists have said.

Senator NELSON. Well, thank you all for participating in this. Anything further?

[No response.]

Senator NELSON. All right. The hearing is adjourned.

[Whereupon, at 12:02 p.m., the hearing was concluded.]

A P P E N D I X

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Testimony of Scott F. Betts
Senior Vice President of National Benefit Services, LLC
Senate Finance Committee Hearing

Retirement Savings 2.0: Updating Savings Policy for the Modern Economy

September 16, 2014

Thank you, Chairman Wyden, Ranking Member Hatch, and members of the Finance Committee, for the opportunity to talk with you about our private employer-sponsored retirement system. My name is Scott Betts, and I am Senior Vice President of National Benefits Services, LLC (NBS). NBS is a fee-for-service Third Party Administrator specializing in the design and administration of all types of employer-sponsored retirement and benefit plans. NBS has more than 225 employees located in West Jordan, Utah, and supports more than 7,500 retirement and benefit plans in 46 states. I am also a member of the American Society of Pension Professionals and Actuaries (ASPPA). ASPPA is a non-profit professional organization with two major goals: to educate all retirement and benefits professionals like myself, and to advocate for policies that give every working American the ability to save for a comfortable retirement.

I am pleased to report that our private employer-sponsored retirement system in general, and 401(k) plans in particular, have been successful at providing substantial retirement benefits for tens of millions of American workers at all income levels. These plans benefit middle class families who represent the overwhelming majority of participants in 401(k) plans: 80 percent of participants in 401(k) plans make less than \$100,000 per year, and 43 percent of participants in these plans make less than \$50,000 per year (see chart #1).¹ The primary factor in determining whether or not a middle-income worker is saving for retirement is whether or not they have a retirement plan at work. Data prepared by the nonpartisan Employee Benefit Research Institute (EBRI) shows that over 70 percent of workers earning from \$30,000 to \$50,000 participated in employer-sponsored retirement plans when a plan was available, whereas less than 5 percent of those middle income earners without access to an employer-sponsored plan contributed to an IRA (see chart #2).² In other words, middle class workers are *15 times* more likely to save for their families' retirement at work than on their own.

Because of the effectiveness of these workplace savings opportunities, it is imperative that no harm is done to the current structure of the tax incentives that have motivated employers to voluntarily sponsor and contribute, along with the employees themselves, to these retirement plans. The tax incentive for retirement savings is unique in that it is a deferral, not a permanent exclusion. No income tax is paid on contributions and investment earnings as long as the money stays in the retirement account, but income tax will be paid in the future when benefits are distributed. Also, the tax incentive for employer-sponsored plans, like 401(k) plans, comes with nondiscrimination rules that ensure contributions do not discriminate in favor of highly compensated employees, and limit the amount of compensation that can be included in determining benefits and testing for nondiscrimination. The result is a tax incentive that is more progressive than our progressive income tax system (see chart #3).

¹Estimate of private sector active participants in 401(k) and profit sharing plans, distributed by adjusted gross income – Source: Internal Revenue Service, Statistics of Income Division.

²Estimate using 2008 Panel of Survey of Income and Program Participation (SIPP) data and 2010 Employee Benefit Research Institute (EBRI) data of workers not covered by an employer plan but saving through an IRA – Source: Employee Benefit Research Institute.

Though the current system is working well for millions of American workers, there are ways to adapt the current rules to enhance retirement plan coverage and simplify the current operation of these employer-sponsored plans. With input from its diverse professional national membership, ASPPA has developed a document entitled *Proposals to Enhance the Private Retirement System*³ which contains more than 30 legislative proposals to improve the current system. These proposals would expand employer-sponsored retirement plan coverage and simplify employer-sponsored retirement plan administration through modest changes to the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act (ERISA). Fortunately, many of these proposals have already been included into bipartisan and bicameral legislation introduced in the current Congress.

Specifically, the private retirement provisions in Title II of Ranking Member Hatch's Secure Annuities for Employee (SAFE) Retirement Act (S.1270) make numerous sensible reforms. These changes will simplify the operation of employer-sponsored retirement plans by eliminating unnecessary paperwork and traps for the unwary, as well as providing new approaches to expand the availability of workplace savings, especially for small business retirement plans. These common sense proposals will go a long way toward improving the retirement security of millions of working Americans. I commend Ranking Member Hatch for offering these long overdue solutions and applaud your committee's commitment to enhancing the private retirement system and the retirement security of our nation's workers.

I will explain first why the current system should be viewed as a success. Then, I will explain the details of these proposals and why they would make such a positive difference for the American people.

The Current System Works

First I would like to review the aggregate amounts of retirement assets accumulated by the American people to date. The numbers are staggering. At the end of 2013, Americans had accumulated more than \$23 trillion in retirement assets. Of that amount, \$5.9 trillion is held in employer-sponsored defined contribution plans of all types. Another \$6.5 trillion is held in IRAs, most of which originated in the form of rollovers from employer-sponsored retirement plans.⁴ Make no mistake, however, the single most important factor in determining whether or not workers across the income spectrum save for retirement is whether or not there is a workplace retirement plan. If increasing retirement and financial security is the goal, increasing the availability of workplace savings is the way to get there.

³[Proposals to Enhance the Private Retirement Plan System](#) (December 2013) – Prepared by the American Society of Pension Professionals & Actuaries Government Affairs Committee.

⁴ Investment Company Institute, [2014 Investment Company Fact Book](#) (May, 2014).

While each person's retirement situation is unique, Fidelity recently conducted a study that aggregated the retirement account balances for clients who had both an investment account through an employer-sponsored retirement plan and an IRA at Fidelity to get a sense of how an average individual participating was performing in the current system. In contrast to reports of "average" 401(k) balances which generally include a wide and disparate variety of age, tenure, and income levels, this study found that for near retirees (ages 55-59), the average combined balance was \$328,257.⁵ That is a substantial amount of money that these individuals can use, in addition to any social security benefit that these individuals may enjoy, to achieve a secure retirement. This data shows that the retirement system works for those that participate in it over the course of their working careers.

The good news is that over 60 million working Americans currently participate in employer-sponsored retirement plans.⁶ Contrary to some reports that suggest only about half of American workers have access to these programs, the Bureau of Labor Statistics (BLS) reports that 78 percent of all full time civilian workers had access to retirement benefits at work, and that 83 percent of those workers participated in these arrangements. While availability and take-up rates are substantially lower for part-time workers, even when they are included in these statistics, BLS found that 68 percent of civilian workers had access to retirement plans, and 80 percent of those participate in the offering. For full time private sector workers, BLS found the access and participation rates are 74 percent and 80 percent respectively, and the access and participation rates for all private-sector workers (including part time) are 64 percent and 76 percent, respectively.⁷

Robust as those results are, alternative research even suggests that these estimates may understate what is actually happening in the workplace. A report from the Social Security Administration, based on an integrated assessment of Census data and W-2 records, found that 72 percent of *all* employees who worked at private companies in 2006 had the ability to participate in a retirement plan, and 80 percent of those participated.⁸ This analysis, which provided the ability to look at actual data, rather than rely on respondent self-reporting, indicates that the BLS statistics on availability are probably understated.

⁵ Fidelity® Retirement Savings Analysis Highlights Higher Balances and Contribution Rates of Investors Saving Beyond Workplace Savings Plans. (February 28, 2013).

⁶ Employee Benefit Research Institute estimates from the March 2013 Current Population Survey.

⁷ Bureau of Labor Statistics, Employee Benefits Survey: Retirement Benefits, March 2013: Retirement benefits: access, participation, and take-up rates: National Compensation Survey March 2013.

⁸ Irena Dushi, Howard M. Iams, and Jules Lichtenstein, Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Records, Social Security Bulletin (2011).

It is important to bear in mind the current set of incentives that efficiently encourage such a high level of voluntary sponsorship of these programs. This efficiency is derived in large part from two features that set the retirement savings incentives apart from other individual tax incentives. First, by choosing to defer the receipt of their 401(k) contributions in their current pay, individuals defer – but do not escape – their tax obligations. Every dollar that is excluded from income this year will be included in income in a future year. Unfortunately, that is not reflected in the cash basis measurement of the retirement savings “tax expenditure.” In fact, the current accounting methodology may overstate the true cost by over 50 percent.⁹ Secondly, nondiscrimination rules for employer-sponsored plans assure the plans do not discriminate in favor of highly compensated employees, and limit the amount of compensation that can be included in determining benefits and testing for nondiscrimination. As a result, this tax incentive is more progressive than the current progressive tax code.

This progressivity can be seen in the accompanying chart (see chart #3), which shows that households with incomes of less than \$50,000 pay only about 9 percent of all income taxes, but receive 27 percent of the defined contribution plan tax incentives. Households with less than \$100,000 in AGI pay about 28 percent of income taxes, but receive about 49 percent of the defined contribution plan tax incentives. Contrast this distribution to the distribution of tax benefit for capital gains, where about 90 percent of the benefit goes to households earning over \$200,000.

This mix of incentives and limits has produced a highly effective voluntary retirement savings structure where these workplace programs exist. And, based on the data cited earlier, we know that middle class workers are *15 times* more likely to save for their families’ retirement at work than on their own. The key is to find ways to expand the opportunity to save in the workplace. We know that there are still millions of workers across the country that do not yet have access to an employer-sponsored retirement plan, particularly those employed with small employers. A key policy focus for those looking to expand and enhance the nation’s retirement security lies in finding ways to make it easier for employers to sponsor these arrangements that we know to be a success.

That is why provisions like those in Title II of Ranking Member Hatch’s SAFE Retirement Act are so important. This legislation directly addresses obstacles that frequently keep employers from sponsoring these arrangements, enhancing the likelihood that more workers will have access to these programs in the workplace. Let me explain how they could make a difference.

⁹ Judy Xanthopoulos and Mary Schmidt, *Retirement Savings and Tax Expenditure Estimates* (April, 2012).

What Proposals Would Make the Current System Even Better

Even with the success of our current retirement system, there are significant hurdles facing employers from taking on the work and responsibility of sponsoring retirement plans for their employees. These complexities discourage small business owners from taking advantage of the tax incentives for maintaining a plan, or incorporating features that would make the plan more effective as a savings vehicle for all employees, because of the *significant* red tape, fines and penalties that can accompany even the most basic of these arrangements. Some complications are statutory and some are regulatory. The proposals contained in the ASPPA document and in Title II of Ranking Member Hatch's SAFE Retirement Act (S. 1270) address these complexities and complications.

The Starter 401(k) Plan

The Starter 401(k) Plan proposed in S.1270 would give employers that do not already sponsor a 401(k) plan a less expensive option to provide a substantial retirement benefit for their employees. The plan allows employees to save up to \$8,000 per year through the arrangement, which is more than individuals can currently save through an IRA, though less than individuals can save through a traditional 401(k) arrangement at present. While the plan does not require employers to make contributions for their employees, it does provide ERISA protections for participants in the plan.

This proposal would also provide start-up companies, who may be reluctant to commit to make employer contributions a way to offer workers a chance to save in a 401(k) plan that could later be easily amended to a traditional 401(k) plan when the business becomes more stable. The Starter 401(k) Plan recognizes that not only are many workers employed by start-ups, but many owners of these entities have very modest incomes themselves and cannot be burdened with retirement contribution requirements when the business is still in the early stages.

Permit Additional Flexibility in Time to Adopt a Retirement Plan

IRS Revenue Ruling 81-114 provides that a deduction for qualified retirement plan contributions is not allowed for a prior taxable year if the plan is not established by the end of that taxable year. Consequently, in order to make deductible contributions for a taxable year, an employer must formally adopt a new qualified retirement plan by the end of such year (unlike a Simplified Employee Pension (SEP) plan, which can be established as late as the due date of the employer's tax filings with extensions).

Frequently, the employer's profitability for a year will be a major factor in his or her decision to establish a retirement plan. This is especially true for small employers. Reliable information on how the business did in the prior year is often not available until

after the close of the employer's taxable year. The provision provided in S. 1270 will allow employers to consider the adoption of a qualified retirement plan, or the addition of non-elective contributions to an existing plan, when the final results of the business for the prior year are available. This flexibility would be instrumental in expanding retirement plan coverage and employer-funded retirement benefits, especially for small businesses. This provision will also place ERISA-covered retirement plans on par with a non-ERISA SEP program.

Interim Amendments

Qualified retirement plans are governed by written documents that must meet certain requirements under the Internal Revenue Code (IRC) to maintain tax-favored status. Revenue Procedure 2007-44, as modified by Rev. Proc. 2008-56 and Rev. Proc. 2012-50, provides staggered dates for plan documents to be submitted to IRS for review as to a plan's qualified status. Individually designed plans are on five-year review cycles, and pre-approved documents are on six-year cycles.

During these cycles, plans must adopt amendments to reflect legislative and regulatory changes to the qualification requirements. Except as provided by law or other guidance, these "interim amendments" must generally be adopted by the due date (including extensions) for filing the income tax return for the taxable year the change is effective. There is no coordination of the due dates of these required "interim amendments" with the cycle for submission of documents to IRS.

S.1270 would eliminate mandatory "interim amendments" which increase the cost and burden of maintaining a plan without any corresponding benefit. The current process is incredibly complicated, with different amendment deadlines that vary based upon the type of amendment and the plan's fiscal year. This can lead to mistakes being made by even the most well-meaning plan sponsors (who are voluntarily providing this benefit). Small plan sponsors in particular are justifiably shocked and surprised when asked to pay thousands of dollars in sanctions when an inadvertent mistake in this amendment cycle is uncovered during an IRS audit. Amendment deadlines coordinated with the plan's 5- or 6-year review cycle would be user friendly and cost-effective. This proposal is a perfect example of a simple and sensible change that would streamline the operation of the plan and remove an unnecessary trap for the unwary, but well-meaning employers who are providing retirement benefits for their employees.

Streamline Plan Testing Requirements

A plan is considered "top heavy" if over 60 percent of the accrued retirement benefits are credited to "key employees." Many small business plans are deemed "top heavy" and, as a result, must provide *all* employees, not just those required to be covered under

ERISA, in those defined contribution plans with a contribution of at least 3 percent of compensation. For a defined benefit plan, the requirement is a minimum accrued benefit of 2 percent of pay per year of service, with a 20 percent maximum. Special rules apply to participants covered under both types of plans. It is important to note that plan sponsors are still required to engage in non-discrimination testing in addition to the “top heavy” testing if a plan is considered “top heavy.”

Unfortunately, these rules serve as a disincentive for employers to add more participants to the retirement plan, especially employees that ERISA allows to be excluded from participation (employees who have not attained age 21 or who have not completed a year of employment with at least 1000 hours of service). Removing this disincentive could easily be accomplished by excluding employees the statute would have allowed to be excluded from participation in the plan from the 3 percent minimum “top heavy” contribution requirement. S. 1270 does this one better, eliminating this extra testing requirement altogether so the employer would not have to worry about allowing more participants to be added to the plan, while still being subject to normal non-discrimination testing requirements.

Electronic Delivery of Retirement Plan Information to Participants

Under current Department of Labor (DOL) regulations, retirement plan disclosures to participants and beneficiaries required under ERISA must be provided on paper unless the participant or beneficiary chooses to receive disclosures electronically. (There is an exception for employees that have access to a computer as an integral part of their duties at work, but the exception is proving too limited to be useful.) The result is a lot of wasted paper and business time and expense to provide participants and beneficiaries with notices that are not read. Compounding the challenges, new DOL fee disclosure rules for individual retirement plan participants impose substantial additional paper disclosure documents. Real-world experience suggests that participants and beneficiaries might be more inclined to read these notices if they were provided on a more useful, interactive, and environmentally friendly basis through electronic means.

Plan sponsors and service providers should be permitted to default plan participants and beneficiaries into receiving documents electronically, instead of requiring an affirmative election. This change would still permit participants and beneficiaries the ability to elect to receive paper disclosures. S. 1270 addresses the DOL’s outdated regulations by allowing all disclosures to participants and beneficiaries required under the IRC and ERISA to be made available to them electronically. Service providers would be required to provide participants and beneficiaries with an advanced notice describing the electronic delivery process and notifying them of their right to opt out of the electronic delivery of documents and receive paper documents instead.

Consolidation and Simplification of Retirement Plan Notice Requirements

S. 1270 makes multiple improvements to plan administration that provide opportunities to consolidate and simplify the multitudes of retirement plan notices to participants and beneficiaries required under the IRC and ERISA. These reforms serve two main purposes that directly benefit the retirement plan participants. First, consolidating and simplifying all the disparate notices into one main, easy to read document increases the likelihood that the information will be read and understood by the participant. Second, consolidating and simplifying these notices reduces the cost to administer the retirement plans, costs that are largely borne by the participants in the plan.

Specifically, S. 1270 allows certain defined benefit plans and certain defined contribution plans that must provide a notice to participants explaining their right to a Qualified Pre-retirement Survivor Annuity (QPSA) to include this notice as part of the Summary Plan Description (SPD). S. 1270 also directs the Secretaries of Labor and the Treasury to adopt final regulations providing that a retirement plan sponsor or service provider may consolidate two or more of the defined contribution employee notices required under the IRC and/or ERISA either into a single notice or consolidate these employees notices into either the SPD or the Summary of Material Modifications (SMM). The retirement plan sponsor or service provider can have this flexibility provided that the combined notice, SPD, or SMM includes the required content and is provided within the time required by law.

Another unnecessary notice that I feel should be eliminated is the notice requirement for the 3 percent safe harbor. The safe harbor information is already provided to participants and beneficiaries in the SPD, and since employees receive the contribution whether or not they contribute to the plan, it does not cause participants to change their behavior.

“Open” Multiple Employer Plans (MEPs)

The DOL has in recent years concluded that the employers must have a relationship other than joint sponsorship of an employer-sponsored plan to participate in a “multiple employer plan.” This determination has effectively decreased the use of these so-called “open” multiple employer plan arrangements, which had gained favor in the marketplace as an option for small employers to provide retirement benefits to their employees.

In response to the DOL’s regulatory action, there have been a number of legislative proposals to explicitly permit the operation of open MEPs in the marketplace. The provision in S. 1270 is, in my view, a good approach that permits open MEPs, while providing safeguards for adopting employers through a designated service provider.

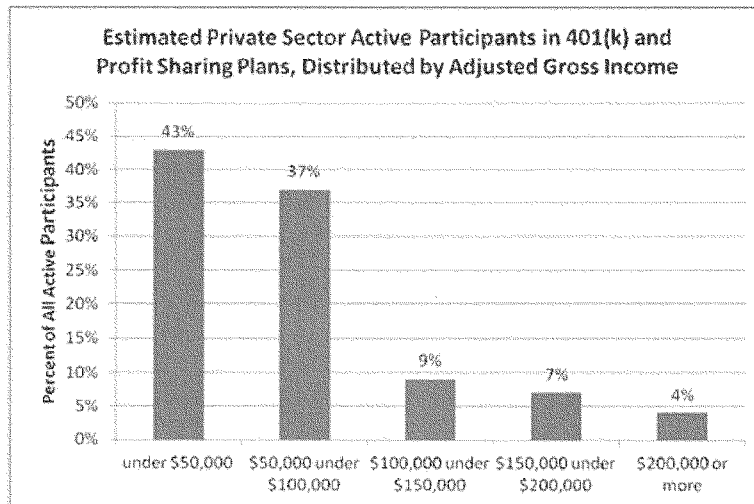
Conclusion

The current retirement system works well for the tens of millions of Americans that have access to it and has proven a successful vehicle for individuals to save for their future. The key to continued and expanding success is enacting reforms that will further incent employers to provide a retirement savings vehicle for their employees. The private retirement provisions contained in Ranking Member Hatch's SAFE Retirement Act (S. 1270) are a huge step in the right direction to expanding the availability of retirement savings and removing certain complexities from the current system so business owners and service providers are able to provide a better retirement plan product to participants.

Thank you, and I would be happy to answer any further questions that the Committee may have.

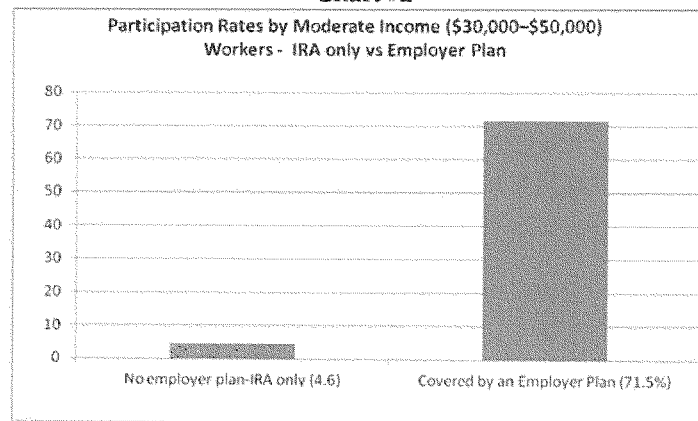
Appendix

Chart #1

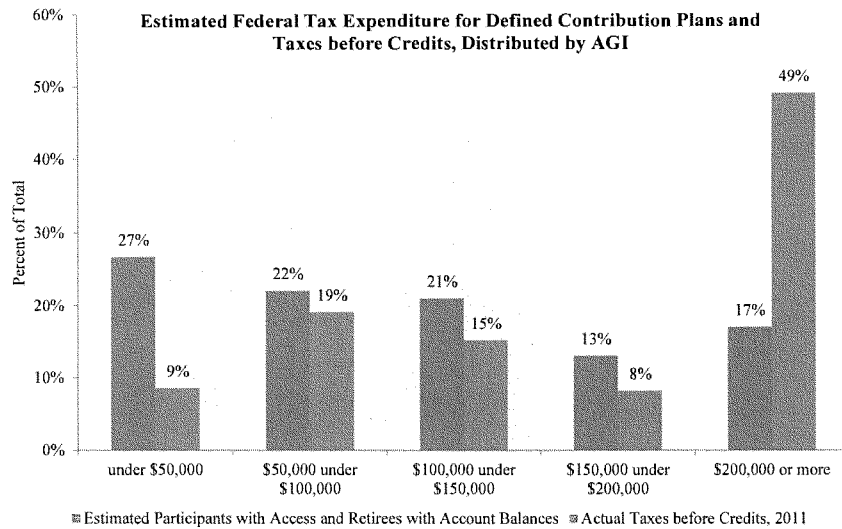


Source: Internal Revenue Service (IRS) Statistics of Income Division (SOI)

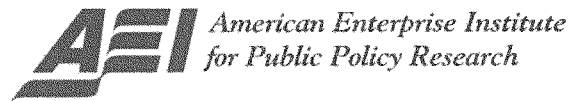
Chart #2



Source: Employee Benefit Research Institute (2010) estimate using 2008 Panel of SIPP (Covered by an Employer Plan) and EBRI estimate (Not Covered by an Employer Plan-IRA only).

Chart #3

Source: "Distributional Analysis and Pension Tax Provisions", American Society of Pension Professionals and Actuaries (April 2014)



Statement before the United States Senate
Committee on Finance

“Retirement Savings 2.0: Updating Savings Policy for the Modern Economy”

Andrew G. Biggs, Ph.D.
Resident Scholar
American Enterprise Institute

September 16, 2014

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Wyden, Ranking Member Hatch and Members of the Committee:

Thank you for the opportunity to testify with regard to the challenges facing Americans as they prepare for retirement.

Americans do not face a “retirement crisis”: while we may read in the newspapers that vast majorities of Americans are underprepared for retirement, the best research – including sophisticated modeling undertaken by the Social Security Administration – shows a more optimistic picture. Many retirees today face income challenges and many will in the future. But the picture today is not of a crisis and the best forecasts do not show retirement security declining significantly as the Baby Boom and Gen-X generations retire. I discuss this research below.

But that does not mean we have nothing to worry about. Even if only one-quarter of Americans are undersaving, and by relatively modest amounts, in a country of three hundred million people that means millions will not be able to maintain their standard of living as they shift from work into retirement. I will discuss who may be falling short in preparing for retirement and what policymakers might do to help.

Finally, I include a brief discussion of a recent controversy over how to measure “replacement rates” for Social Security benefits.

Introduction

There is a widespread perception that our country faces a “retirement crisis.” For instance, the National Retirement Risk Index published by the Center for Retirement Research at Boston College states that at least 53% of Americans are “at risk” of an insufficient retirement income, with higher numbers once we account for retiree health costs.¹ The National Institute on Retirement Security goes further, claiming that up to 84% of Americans are underprepared and that the total “retirement savings gap” approaches \$14 trillion.² A recent study from the New America Foundation claims that Americans receive little retirement income from IRA and 401(k) plans, and proposes to do away with tax preferences for private retirement saving and to expand Social Security benefits by 50%.³

These claims, I believe, are mistaken.⁴ The studies cited above tend to underestimate the incomes that Americans will have in retirement while overestimating how much Americans will need to maintain their pre-retirement standards of living. Other research, including research from the Social Security Administration, shows a different picture. Yes, there are some future Americans who will fall short in retirement, just as there are some retirees who are falling short today. But this research does not support the claim that retirement security is rapidly eroding and does not, to my mind, justify turning our retirement system upside down.

Do we have a retirement crisis today?

It is worth starting by evaluating the status of retirees in America today. According to the Census Bureau, the poverty rate for people aged 65 and older was 9.1%, versus 13.7% for those aged 18 to 64 and 21.8% for children under age 18.⁵ Moreover, the poverty rate among retirees is almost certainly overstated, because the Census Bureau does not count most withdrawals from IRA and 401(k) retirement accounts as “income.”⁶

But an adequate retirement income isn't merely one that keeps you out of poverty. A more important measure of retirement income adequacy, which applies to rich and poor alike, is whether your retirement income allows you to maintain your pre-retirement standard of living. This approach is consistent with the "life cycle model" in economics, in which individuals prefer to smooth their consumption from year to year rather than having a pattern of feast-and-famine.

One way to measure retirement security is via "replacement rates." A replacement rate as commonly understood in the U.S. measures an individual's retirement income as a percentage of that individual's pre-retirement earnings. Financial advisors generally measure replacement rates relative to earnings immediately prior to retirement; policy analysts often favor career-average earnings adjusted for inflation, as this measure better reflects the total purchasing power – and thus the standard of living – a person enjoyed in their pre-retirement years.

The Social Security Administration's Office of Retirement and Disability uses a sophisticated computer model known as "MINT" (Modeling Income in the Near Term) to estimate incomes for current and future groups of retirees. MINT was developed beginning in the late 1990s in cooperation with the Urban Institute, the RAND Corporation, and the Brookings Institution. MINT combines Social Security earnings records, Census survey results and other data to simulate thousands individuals over their full lives: person-by-person, year-by-year, program-by-program. Each year the model simulates individuals' earnings, education, health status, work, marriage, disability, and retirement saving. MINT calculates not just Social Security benefits, but also earnings, asset income, pensions and government benefits such as SSI, Food Stamps, WIC, TANF and even heating and rental assistance. MINT is currently in Version 7 and the model is regularly peer-reviewed by experts both inside and outside the SSA.

According to SSA's MINT model, the so-called "Depression Babies" (born 1926-1935) had a median income at age 67 equal to 109% of the household's career-average earnings adjusted for inflation. SSA estimates that the "War Babies" (born 1936-1945) had a median replacement rate of 119% of average pre-retirement earnings. The "Leading Boomers" (born 1946-1955), who are retiring today, have an estimated replacement rate of 116% of average pre-retirement earnings.⁷

The question is, are these replacement rates sufficient to allow retirees to match their pre-retirement standard of living? A 2009 research paper commissioned by the SSA and authored by economists John Karl Scholz and Ananth Seshadri of the University of Wisconsin estimated that a typical household could maintain its standard of living from work into retirement if it had a retirement income equal to 68% of its inflation-averaged pre-retirement earnings.⁸ By this standard, the MINT figures indicate that the typical retiree today is faring quite well. Moreover, the MINT model indicates that only around 26% of current retirees have retirement incomes below 75% of their average pre-retirement earnings and only 8% had replacement rates below 50%. From these figures, it is difficult to conclude that current retirees face a "crisis."

An alternate way to judge the income security of current retirees is simply to ask them: according to Gallup, 75% of current retirees report having enough money to live comfortably.⁹ Ohio State economist Jason Seligman finds, using data from the federally-sponsored Health and Retirement Study, that 68% of current retirees deem themselves "very satisfied" in retirement, with another 23% calling themselves "moderately satisfied." Just 14% report that their retirement years are "not as good" as the years immediately preceding retirement.¹⁰ RAND Corporation economists Michael Hurd and Suzanne Rohwedder find that most current retirees "seem to be

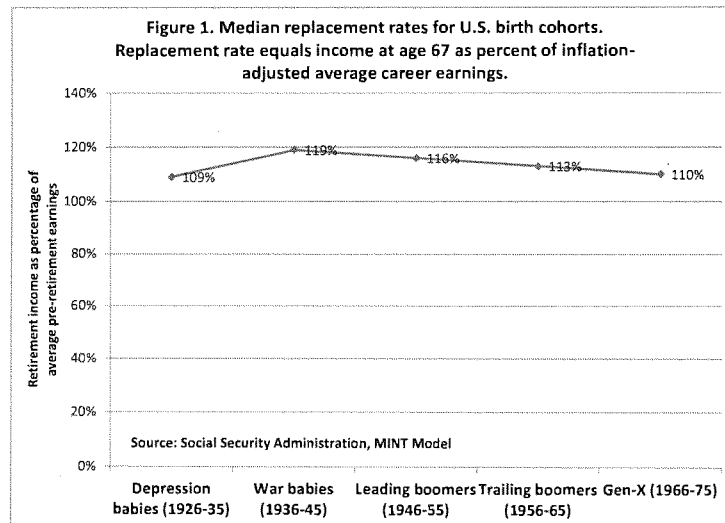
pleasantly surprised by their level of resources.”¹¹ So retirees’ perceptions seem to match up with the data: there doesn’t seem to be a retirement crisis today.

Will there be a retirement crisis in the future?

If there isn’t a retirement crisis today, it does not seem likely there will be one in the future, as the best retirement models do not project that future retirees will have significantly lower replacement rates than current retirees.

Figure 1 shows the SSA MINT model’s projections of replacement rates for current and future cohorts of retirees. MINT’s modeling of retirement saving is far more sophisticated than that of the headline-producing studies you may read about. MINT’s pension module tracks the decline of traditional defined benefit pensions and the spread of 401(k)s, including innovations such as automatic pension enrollment. It even estimates the mix of investments that individuals choose, and now incorporates “life cycle” funds that shift from stocks to bonds as workers near retirement. By contrast, it has recently been pointed out that some models that predict a “retirement crisis” may partially rely on stale data on 401(k) plans from the 1980s, when these plans were only getting started.¹²

As noted above, SSA’s MINT model estimates that today’s retirees had income replacement rates at age 67 of between 109 and 119% of their career-average pre-retirement earnings, adjusted for inflation. For the Trailing Boomers (born 1956-1965) MINT project a median replacement rate of 113%. The GenXers (born 1966-1975) have a projected median replacement rate of 110%.



These simply aren't big differences. In fact, SSA projects that the GenXers will have the same replacement rates as the Depression birth cohorts, who enjoyed the "Golden Age" of retirement where traditional defined benefit pensions were more common widespread and Social Security benefits more generous. The reality is that the "Golden Age" wasn't so golden: most workers didn't have traditional pensions, and many who did participate in such plans failed to vest in their benefits. Likewise, today's retirement situation isn't nearly as bad as many critics like to claim.

Nor do the MINT model's projections show an emerging retirement underclass that lives in poverty even as others do well. As noted above, MINT estimates that only 26% of Depression Babies had replacement rates below 75% and only 8% had replacement rates below 50%. For the GenXers, who it is claimed face a retirement crisis, MINT projects that 25% will have replacement rates below 75% and 8% will have replacement rates below 50%. These are hardly figures to inspire apocalyptic reactions.

The Employee Benefit Research Institute developed its own Retirement Security Projection Model which comes to broadly similar conclusions: "the overall retirement income adequacy prospects for GenXers [are] approximately the same as Early Boomers and Late Boomers," EBRI says.¹³

The face of retirement income is changing dramatically: for instance, MINT projects that half as many future retirees will receive income from traditional DB pensions while twice as many will retire with IRAs and 401(k) accounts. But SSA's MINT model, which is the most sophisticated in the business, does not project large changes in the overall level of income adequacy for future generations of retirees.

What does this mean for retirement policy?

Just because we don't face a retirement crisis does not mean that every retiree will be financially secure. Nevertheless, the solutions to a smaller, more targeted problem are different than when the retirement system seems to be failing for the vast majority of people.

RAND economists Michael Hurd and Susanne Rohwedder find that 71% of Americans currently aged 66-69 are adequately prepared for retirement.¹⁴ Likewise, the University of Wisconsin's Karl Scholz and Ananth Seshadri along with the Brookings Institution's William Gale conclude that only around 26% of households are currently under-saving for retirement. Those who are under-prepared have savings about 17% below where they should be. The authors conclude that while "some households will need to ratchet their living standards downward in retirement, most Americans are, by in large, preparing sensibly, given the existing generosity of social security, Medicare, and pension arrangements."

This picture is consistent with the SSA MINT figures I cited above, but is very different from the studies that so often generate headlines. Where we need more and better research is figuring out precisely *who* those under-prepared Americans are, by *how much* they fall short of their saving goals, and *what can be done* to help them. For instance, while Hurd and Rohwedder find that most Americans are well-prepared for retirement, they also find that only 29% of single women without a high school education are well-prepared for retirement. This is a small group, but within that group the need is great. These individuals are less likely to have access to an employer-sponsored pension plan. Moreover, because Social Security's benefit formula favors

married couples over individuals, single low-income women may not do as well from the system as others.

Percentages of Americans Ages 66–69 Adequately Prepared for Retirement (Source: Hurd and Rohwedder 2014)							
Education Level	All	Single Persons			Married Persons		
		All Single Persons	Males	Females	All Married Persons	Males	Females
Did not complete high school	54%	36%	64%	29%	70%	70%	70%
High school	74%	62%	67%	61%	80%	77%	81%
Some college	71%	54%	63%	51%	81%	77%	83%
College and above	83%	69%	65%	70%	89%	87%	90%
All	71%	55%	65%	51%	80%	78%	81%
Hurd, Michael D., and Susann Rohwedder. "More Americans May Be Adequately Prepared for Retirement Than Previously Thought." (2014).							

SSA's MINT model has the data necessary to conduct these kinds of analyses at the level of detail that can inform policymakers and SSA's Office of Retirement and Disability Policy has staff qualified to undertake such research. As elected officials you might encourage the agency's leadership to support research of this kind.

Given what we do know, however, we can propose several steps.

Automatic enrollment in retirement plans is probably the single most effective step we could take to increase retirement saving. My own view is that auto-enrollment is far more effective than other policies, such as contribution matches, and should be the default for any employer wishing to improve the retirement security of its employees. Prof. Madrian, who is also testifying at today's hearing, is probably the nation's leading expert in this area.

Investment costs are also an important factor, as Mr. Bogle can testify. Costs are generally expressed as a percentage of assets under management, which means that the impact of these costs is easily grasped: if a mutual fund has an administrative cost of 1% of assets, then the net return to the employee will be 1 percentage point lower than under a (hypothetical) zero-cost plan. Every investment carries some costs, and administering plans will be more expensive for small employers than for large plans. Nevertheless, I believe that focusing pension offerings on low-cost index funds, as the federal Thrift Savings Plan does, could be of great benefit to savers.

A broader question is how to increase access to retirement saving plans for those who are not currently offered a pension. Research from the Social Security Administration using employer tax records found that 72% of all workers in 2006 were offered a retirement plan by their employer; among firms with 100 or more employees, 82% of workers were offered a retirement plan.¹⁵ This is a significantly higher rate of pension offering than the 50% figure that often is cited, but which relies upon less reliable surveys of employees rather than employer tax records.¹⁶ Nevertheless, SSA found that only 34% of employers with fewer than 10 employees,

and 46% of employers with 10-24 employees, offered a retirement plan. These smaller employers cite the complexity and costs of maintaining a plan, which can include legal, accounting, consulting, record-keeping and communication services. For a small business this may simply be more than they can handle. Some experts propose a “Super Simple” savings plan that reduces cost and complexity for small employers while maintaining the tax benefits that make 401(k) plans attractive.¹⁷

It also is worth addressing proposals that I believe are more problematic. Specifically, a number of plans exist in the House, Senate and think tanks to expand the Social Security program. Social Security is already underfunded by more than \$10 trillion over the next 75 years. According to the CBO, Social Security's long-term shortfall has quadrupled over the past six years, from 1% of payroll to 4%. Expanding Social Security under these circumstance raises problems that are almost too obvious to mention.

In the interest of clarity, however, I will mention two. First, such plans “use up” policy options that that previously had been pegged for restoring Social Security's solvency and instead use them to raise benefits. For instance, some people favor improving Social Security's finances by lifting the \$117,000 ceiling upon which payroll taxes are levied. This would generate additional revenues for the program. Most Social Security expansion plans also lift the so-called “tax max” but use the extra revenues to increase benefits. These plans do relatively little to improve Social Security's finances, but leave fewer options on the table when Congress does eventually act on Social Security reform.

Moreover, it's not clear that raising benefits across the board would help the people who are mostly likely to be falling short in retirement. For instance, I mentioned above that single, less-educated women appear to be at particular financial risk in retirement. What you may not know is that, under Social Security's benefit formula, a single, low-income woman who works and contributes to Social Security every year of her life would receive a lower benefit in retirement than the non-working spouse of a high-wage earner. This is despite the fact that the single woman both needs the benefits more and has paid more into the program. Likewise, individuals with full working careers are often penalized versus those who fit all their earnings into just 35 years, the period over which Social Security averages earnings in order to calculate benefits. Single women have significantly greater labor force participation than married women and thus are more likely to be denied credit for working more than 35 years. An across-the-board benefit increase won't fix this problem.

Similarly, the Social Security Administration estimates that 4% of retirees will never receive benefits from the program. These so-called “never-beneficiaries” have

lower education levels and higher proportions of women, Hispanics, immigrants, the never-married, and widows than the beneficiary population. Never-beneficiaries have a far higher poverty rate (about 44%) than current and future beneficiaries (about 4%). Ninety-five percent of never-beneficiaries are individuals whose earnings histories are insufficient to qualify for benefits.¹⁸

And under proposals to expand Social Security, these individuals would remain never-beneficiaries because these plans deal principally with benefit levels, not the way people qualify for benefits or how those benefits are allocated.

To address these issues, I and others have proposed a universal, flat benefit paid to all retirees, regardless of their earnings or workforce participation. On top of this, individuals would save for retirement in accounts that would supplement Social Security.¹⁹ This approach would effectively take the poverty rate among seniors from about 9% to zero percent, while making Social Security a more reliable and understandable social insurance benefit for those who need it the most. Yes, middle and high income workers would need to save more on their own. But these are individuals who could, should and would save more for retirement if they saw the need to do so. Other countries' pension plans, such as in the United Kingdom, New Zealand, Australia and Canada, embrace this broad theme. Such an approach can improve retirement security, lower poverty rates, and increase real retirement saving.

In short, we don't need to make Social Security larger so much as make it work better.

Appendix: The Replacement Rates Controversy

In recent months a debate has developed over how to calculate “replacement rates” for Social Security. Replacement rates are a common measure of benefit adequacy, but there is no single agreed-upon way in which to calculate replacement rates. This can create confusion among consumers of this information. For instance, financial advisors often recommend that retirees have a replacement rate of 70% of their final earnings immediately prior to retirement. But one cannot apply this 70% target to replacement rates calculated in other ways. For instance, SSA has commonly stated that a typical individual receives a replacement rate of 40 percent from the program, but this figure is calculated by SSA’s actuaries using a different method. Thus, in my view, there is an apples-and-oranges problem.

Until 2014, the annual Social Security Trustees Report published replacement rates for stylized individuals at different earnings levels. The Trustee’s 2013 Report makes clear that discomfort was growing with regard to how these figures were calculated. The Trustees noted that SSA’s

method of calculation produces percentages that may differ significantly from those that would be produced by comparing benefits to these representative workers’ recent average earnings levels or to other more common measures of pre-retirement income.²⁰

In 2014, the Trustees Report ceased publishing replacement rates. SSA’s Office of the Chief Actuary has recently published Social Security replacement rates under its own auspices and issued an actuarial note defending its figures.²¹

Not surprisingly, these events have generated controversy, including accusations of political manipulation. In reality, what is happening is a technical – but very important – debate among retirement policy analysts. The whole debate cannot be outlined here, but it might help to distinguish between two types of replacement rates:

- *American-style replacement rates*: these measure a retiree’s income as a percentage of *that retiree’s* previous earnings and thus represent the degree to which the retiree can maintain his pre-retirement standard of living.
- *European-style replacement rates*: these measure retirees’ incomes in a given year as a percentage of workers’ incomes in that same year, and thus compares retirees’ standard of living to that of working-age members of society.

The point isn’t that one approach is better than another, but that they measure very different things. Economists Olivia Mitchell of Wharton and John Phillips of the National Institutes of Health state that the ratio of pension benefits to average wages “is commonly used in Europe, where retirement adequacy is often judged according to whether retirees maintain a given relative position vis-à-vis current working cohorts.” But, Mitchell and Phillips, note “Historically in the United States, policy makers have tended to prefer a replacement rate measure tied to workers’ own past earnings.”²²

While SSA’s actuaries describe their figures as American-style replacement rates, in reality the actuaries’ figures are European-style replacement rates which compare benefits paid to retirees today with the wages earned by workers today. This is easily demonstrated with data from Table V.C7 of the 2014 Trustees Report, which includes annual benefit amounts for SSA’s stylized workers retiring in a given year along with the annual wages paid to workers in that year. To illustrate, SSA’s stylized medium earner retiring in 2014 receives an annual benefit of

\$19,477; the average wage paid to workers in 2014 is estimated at \$46,787. Divide the two figures and get 41.6%, which is almost precisely equal to the 41.1% replacement rate published by SSA's actuaries that purports to compare the median earner's benefits to his own *pre-retirement* earnings.²³ Simply put, the replacement rate figures that previously were published in the Social Security Trustees Reports do not represent what most readers think they represent, and thus they may incorrectly shape perceptions of retirement income adequacy and Social Security policy.

SSA's Office of the Chief Actuary has cited international organizations such as the OECD, stating that SSA is following an "internationally recognized standard" in calculating replacement rate. But the OECD as an institution explicitly defines the replacement rate as "The ratio of an individual's (or a given population's) (average) pension in a given time period and the (average) income in a given time period."²⁴ The World Bank and IMF also measure replacement rates relative to average incomes at the time, but similarly do not claim that these figures are measures of retirement income adequacy.²⁵ SSA's actuaries point to a single OECD publication that *describes* its replacement rates as being measured relative to pre-retirement earnings, but this publication – like others from the OECD, IMF and World Bank – in fact compares benefits paid to today's retirees to the incomes of today's workers.

When we measure replacement rates relative to workers' prior earnings, the adequacy of Social Security benefits appears to be higher. For instance, while the standard belief is that Social Security pays a typical worker a replacement rate of around 40 percent of his pre-retirement earnings, in a 2008 study published with Glenn Springstead of SSA I found that the median household aged 64-66 in 2005 received a Social Security benefit equal to 53 percent of its inflation-adjusted career-average earnings.²⁶

But further research is necessary: the replacement rates that Social Security pays to beneficiaries vary widely: even among retirees with the same lifetime earnings, some receive very high replacement rates and others receive much lower replacement rates.²⁷ At the same time, Scholz and Seshadri show that the target replacement rates for households also vary considerably, based upon factors such as marital status, income level, and the number of children a household has. While the authors calculated a median target replacement rate of 68 percent of inflation-averaged lifetime earnings, 48 percent of households have optimal replacement rates below 65 percent and 37 percent of households have optimal replacement rates above 90 percent. At this time we have little idea of how well Social Security is matching replacement rates to households' actual needs. But this is the sort of research topic that SSA's Office of Retirement and Disability Policy is well-situated to address.

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- ² Nari Rhee, "The Retirement Crisis: Is It Even Worse Than We Think?" The National Institute on Retirement Security. June 2013.
- ³ Lind, Michael, Joshua Freedman, Steven Hill, and Robert Hiltonsmith. "Expanded Social Security: A Plan to Increase Retirement Security for All Americans." New America Foundation. April 2013.
- ⁴ The discussion here draws upon Biggs, Andrew G. and Sylvester J. Schieber. "Is There a Retirement Crisis?" *National Affairs* 20, Summer 2014, pp. 55-75. Also see Pang, Gaobo, and Sylvester J. Schieber. "Why American Workers' Retirement Income Security Prospects Look So Bleak: A Review of Recent Assessments." *The Journal of Retirement* 2.1 (2014): 35-54.
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- ⁷ See Butrica, Barbara A., Karen E. Smith, and Howard M. Iams. "This Is Not Your Parents' Retirement: Comparing Retirement Income Across Generations." *Social Security Bulletin* 72 (2012): 37.
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- ¹⁴ Source: Hurd, Michael D., and Susann Rohwedder. "More Americans May Be Adequately Prepared for Retirement Than Previously Thought." (2014). Also see Hurd, Michael D., and Susann Rohwedder. "Adequacy of economic resources in retirement and returns-to-scale in consumption." Michigan Retirement Research Center Research Paper No. WP 174 (2008).
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- ¹⁷ Perun, Pamela, and C. Eugene Steuerle. 2008. "Why Not a 'Super Simple' Saving Plan for the United States?" Washington, DC: The Urban Institute. Opportunity and Ownership Project Report 3.
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found a significantly lower replacement rate of around 45 percent of inflation-adjusted pre-retirement earnings for individuals claiming benefits in 2011. A variety of factors could account for this difference: First, Biggs and Springstead (2008) measured replacement rates on the more economically-relevant household basis while Goss et al (2014) measure them on an individual basis; the dataset used by Goss et al (2014) does not allow for household measurements. Second, Biggs and Springstead (2008) measured replacement rates for a household with median earnings, while Goss et al (2014) measured the median replacement rate, which may differ. Third, Biggs and Springstead (2008) included all non-disabled beneficiaries and all benefits paid to them, while Goss et al (2014) exclude spouse-only and widow-only beneficiaries and, for retired worker beneficiaries, exclude supplemental spousal and widow benefits. While excluding spouse/widow-only beneficiaries may make sense when replacement rates are calculated on an individual basis, since replacement rates would be extremely high, these beneficiaries should be included in a household calculation where such issues do not arise. Benefits for dually-entitled retired workers should be included in either an individual- or household-level replacement rate calculation. Nearly half of female retired worker beneficiaries receive supplemental spousal or widow benefits and, on average, these supplements increase total benefits received by such individuals by over 75 percent, according to SSA's Statistical Supplement. Fourth, the time period in which replacement rates were measured differed in regard to inflation, wage growth, and labor force participation and earnings of older workers, which generate different replacement rates in retirement.

²⁷ See Biggs, Andrew G. "Will Your Social Insurance Pay Off? Making Social Security Progressivity Work for Low-Income Retirees." AEI Retirement Policy Outlook 1 (2009).

Testimony of John C. Bogle
Founder of the Vanguard Group
Before the Finance Committee of the United States Senate
September 16, 2014

I. Background – Retirement Plans for Our Citizens

I've studied the issues facing American's retirement system for many decades, and have written extensively on this subject. I'm appending to this testimony three of my recent writings on these issues:

- First, **Chapter 7 of my 2012 book, *The Clash of the Cultures***. The chapter is entitled "America's Retirement System—Too Much Speculation, Too Little Investment." I conclude that, "our nation's system of retirement security is imperiled, headed for a serious train wreck." I describe easily achievable reforms in funding the retirement plans of our citizens, "if only we have the wisdom and courage to implement them."
(Appendix I)
- Second, **my paper entitled "The 'All-In' Costs of Mutual Fund Investing."** It was published in the January/February 2014 issue of the *Financial Analysts Journal*, and focuses on defined contribution (DC) retirement plans, which are gradually replacing the traditional and once-dominant defined benefit (DB) pension plans. Here, I focus on mutual funds, the largest single pool of assets in the DC field. I conclude that the high costs of ownership of mutual fund shares, over the long-term, are likely to *confiscate as much as 65 percent or more of the wealth that retirement plan investors could otherwise easily earn*, simply by diverting market returns from fund investors to fund managers.
(Appendix II) Many of the infirmities of our retirement system are the result of the heavy costs incurred by investors because of our bloated financial system.
- Third, **my essay for *The Wall Street Journal's* 125th anniversary issue on July 7, 2014, titled "The Incredibly Shrinking Financial System."** Looking to the future, I predicted that: 1) The financial industry will shrink from its present all-time high of about 10% of GDP, as investors continue to adopt simple, middle-of-the-road investment strategies. 2) Speculation will decline, as investors take heed of the mounting evidence that consistently shows that the stock trading done on Wall Street subtracts value from the

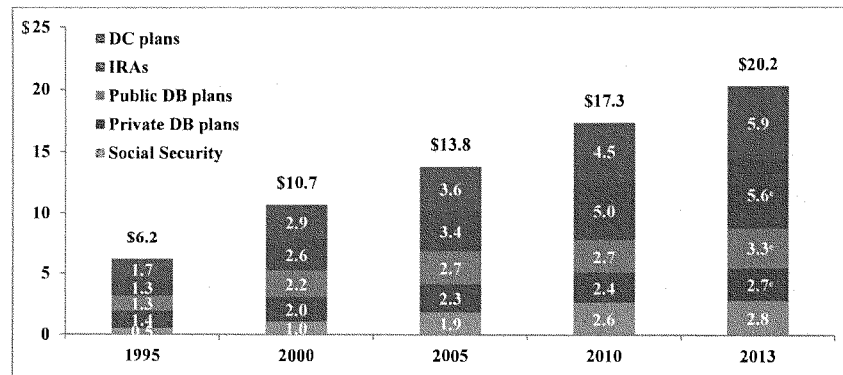
market returns that investors earn. 3) Distrust of active managers will grow as investors continue to adopt index funds as the core of their investment portfolios. 4) Corporate governance will finally emerge as a top priority of institutional money managers, which collectively hold more than 65% of all shares of U.S. stocks. These agents hold virtual control over corporate America. They will come to recognize their fiduciary duty to do what is right for their clients, and take seriously the rights and responsibilities of corporate ownership. (Appendix III)

II. The Nation's Retirement System

The failure of our retirement system is pervasive. Today's system constitutes, if you will, a three-legged stool, and all three legs are faltering. These retirement systems constitute an enormous portion of the financial assets held by our nation's families—some \$20 trillion. **Exhibit 1** presents the assets of the major components:

Exhibit 1: U.S. Retirement System Assets

Trillions of dollars



Sources: Investment Company Institute, Federal Reserve Board, Department of Labor, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, Social Security Administration, Bureau of Economic Analysis and Internal Revenue Service Statistics of Income Division.

Excludes plans not listed, such as all fixed and variable annuity reserves at life insurance companies (less annuities held by IRAs, 403(b) plans, 457 plans), and federal pension plans.

This system faces profound challenges across the board:

- **Social Security:** Now significantly underfunded, the result of decades in which, essentially, payroll tax revenues have fallen short of payments to beneficiaries. To protect the long-term solvency of the system, we need to implement a gradual increase in the maximum income level subject to the payroll tax; a change in the formula for establishing benefit levels from the present wage-increase-based formula to an inflation-based formula; a gradual increase in the retirement age to, say, 69; and a modest means test that limits payouts to our wealthiest citizens. Voila! The job will be done! While it will take statesmanship and determination on the part of our policymakers and legislators to take action, **these changes are well within our nation's means.**
- **Defined Benefit Plans:** The role of *private* DB plans in our retirement system has sharply diminished, although present assets—some \$2.7 trillion—remain substantial. In an effort to reduce corporate operating expenses and increase earnings to shareholders, our corporations have gradually abandoned or altered DB plans in favor of defined contribution (DC) plans. On the other hand, *public* DB plans (largely state and local governments and agencies) have tripled since 1995, to some \$3.3 trillion today.

These plans are already underfunded by hundreds of billions of dollars. What's more, virtually all plans—private and public alike—are assuming overly optimistic future investment returns of about 8% per year on their pension assets. The assumption of an 8% return seems absurd. Today, U.S. Treasury bonds have yields of around 3%, and future stock returns seem likely to be in the 7% range. Under these assumptions, a 60/40 stock/bond portfolio might be expected to return about 5½% during the coming decade—much less than 5½% after the costs of investing are deducted. This “bad math”—assuming an 8% return when something on the order of 5% seems more realistic—must be corrected, with increased funding and realistic expectations for future returns. **These changes will be disruptive and painful.**

- **Defined Contribution Plans:** I've saved until last my comments on this third leg of our nation's retirement stool. These plans presently represent the core of our nation's

commitment to retirement security, and they will drive the future growth in retirement plan assets. Since 1995, DC plans (including IRAs) have grown four-fold, to about \$12.4 trillion, and account for almost two-thirds of the aggregate assets of our retirement system. As I'll explain shortly, our DC plan system is structurally unsound. **But it's relatively easy to repair without huge costs or major changes in its terms and conditions.**

Defined Contribution Plans

Serious questions surround the DC concept. Most importantly, as private DB plans are replaced by DC plans, there is a massive transfer of investment risk from corporations to individual investors, many—perhaps most—of whom lack the knowledge and understanding of the principles of sound investing. At the same time, the maximum protection against longevity risk (the risk of outliving one's income) provided to beneficiaries of DB plans has vanished. DC plans offer essentially no protection whatsoever against longevity risk. These two problems only scratch the surface of the slate of problems facing DC participants.

It is in IRAs—with \$6.5 trillion in assets, the largest portion of DC plans—that we find the most serious problems. Contributions are voluntary, so there is no discipline to invest regularly. Most investors start their IRAs too late in life, when contributions required to build a meaningful nest-egg must be far higher than if the plan were started at the beginning of one's career. (In fairness, many families give the accumulation of education funds for their children a higher priority.) Withdrawals of capital can be made almost at will, with only a modest tax penalty. (Imagine how well Social Security would work if we could withdraw our capital at will.)

But the biggest problem—and the biggest opportunity—lies in how IRA holders invest their hard-earned wealth. Decisions regarding appropriate asset allocation between stocks and bonds is often far too casual. Investment choices seem based largely on the past performance of actively managed funds; accomplishments that almost always (always?) fade away. Further, there are often substantial investments in employer stock, combining investment risk with career risk. Despite the reality that higher transaction activity (trading) leads to lower investment returns, trading by IRA participants rises once Wall Street's salesmen get involved, often when a DC plan is “rolled over” to an IRA when the participant retires.

The Powerful Role of Investment Costs

I now turn to the *absolutely essential need* to reduce the costs of investing for investors in both corporate defined contribution plans and IRAs. My message to the Finance Committee is “**Little things mean a lot.**”

Here, I draw on my paper published in *Financial Analysts Journal* earlier this year, “The Arithmetic of ‘All-In’ Investment Expenses.” I expound on a year-earlier article entitled “The Arithmetic of Investment Expenses,” by Stanford professor and Nobel Laureate William Sharpe. Dr. Sharpe’s paper, calculated by using relative expense ratios (fund expenses as a percentage of fund assets), investing in a low-cost stock market index fund gave investors an *additional* annual return of about 1% over investing in typical actively managed equity funds. Over the long term, this difference becomes enormous. In his words:

... a person saving for retirement who chooses low-cost investments would have a standard of living throughout retirement more than 20% higher than that of a comparable investor in high-cost investments.

My paper simply took Dr. Sharpe’s analysis of expense ratios to a more comprehensive comparison of “all-in” fund costs—including cash drag, portfolio turnover costs, and sales loads and fees for investment oversight and advice. Including these items brings total investment costs of actively managed, high-cost funds to an estimated 2.2% per year, double Dr. Sharpe’s differential. (He applauded my analysis.)

My data showed (assuming a 7% nominal annual return on equities) that a 30-year-old investor, earning a \$30,000 annual salary that grows at 3% per year, investing 10% of annual compensation in a tax-deferred retirement plan, and retiring at age 70 would have built the following retirement fund accumulations:

- Actively Managed Fund - \$561,000.**
- Index Fund - \$927,000.**

That is, using Dr. Sharpe’s framework, but with a more comprehensive estimate of fund costs:

*A person saving for retirement who chooses low-cost investments could have a standard of living throughout retirement **more than 65% higher** than that of a comparable investor in high-cost investments.*

So why do investors use high-cost mutual funds? “Buttonwood,” writing in London’s *Economist* explains it bluntly:

Everyone knows that if you go to a casino, the odds are rigged in favour of the house. But people still dream of making a killing. The same psychology seems to apply to fund management, where investors flock to high-cost mutual funds even though the odds are against them. Russel Kinnel, the director of fund research at Morningstar, has described fund costs as “the most dependable predictor of performance. It is really a simple matter of maths.”

The *Economist* columnist endorsed my perspective. “Some will argue that Mr. Bogle’s numbers are exaggerated . . . However, such arguments do not make much of a dent in Mr. Bogle’s case.”

Additional Flaws

While the obvious and essential role of fund costs in shaping the long-term returns of retirees who choose mutual funds is by far the major issue affecting retirement plan adequacy, the very structure of DC plans is also profoundly flawed.

A major part of the problem is that corporate DC plans were designed as *thrift* plans, not *retirement* plans. To a greater or lesser degree, corporate DC plans simply (and paradoxically) give their beneficiaries and owners too much flexibility. A few examples:

- 1) **Limited participation.** Fully 20% of eligible participants fail to join corporate plans.
- 2) **Early withdrawals.** “Hardship” withdrawals are granted far too easily.
- 3) **Loans** against DC plan assets are not adequately strict, and repayments too easily extended.
- 4) **Job changes** allow investors immediate access to their plan assets; some investors keep their plans, some move them to their new employer; some simply spend them.

In IRAs, this flexibility is virtually unlimited (except for modest tax penalties on withdrawals), and the potential damage to retirement-funding commensurately larger.

These flaws can be corrected with relative ease, but we can expect enormous resistance from lobbyists for mutual fund managers and industry associations. Yet provided that changes that correct these flaws were implemented, the DC plan can prove to be an even sounder route to investment success than its DB cousin. In DC plans, investors can set asset allocations that suit *their own* investment objectives and risk tolerance. The investment cost differential in favor of DB plans could easily be mitigated or even eliminated with the use of low-cost index fund providers. (A requirement that *only* index funds be eligible investments is desirable, but unlikely to survive fund industry opposition.)

Setting a New Paradigm for IRA Investors

However little recognized, the essential syllogism in our financial system is obvious and unarguable:

1. Wealth is created by corporate America, not by Wall Street.
2. That wealth—essentially the dividend yield plus the earnings growth of a corporation—accounts for 100% of the long-term returns generated in the stock market.
3. Investors, as a group, own the entire stock market, and earn 100% of its return, *before the intermediation costs that they incur*.
4. Investors who pay the lowest intermediation costs (mostly management fees, trading costs, and the costs of share distribution) earn higher return than all other investors as a group.

Conclusion: If we investors collectively own the market, but individually compete to beat our fellow market participants, we lose. But if we abandon our inevitably futile attempts to obtain an edge over other market participants and simply buy and hold our share of the market portfolio, we win.

Too many IRA investors seem blithely unaware of this tautology. They subject themselves to high-cost actively-managed mutual funds, often trading them with alacrity, a counterproductive behavior that destines them, paradoxically, to earning lower returns than the returns earned by the funds that they choose.

An Industry Grows, and Loses Its Way

When a profession with elements of a business becomes a business with elements of a profession—an accurate description of the gradual change I have witnessed during my 63 years in the mutual fund industry—the producers (fund managers and marketers) are advantaged at the expense of the consumers (fund investors).

For example, since 1999 the assets of all stock and bond mutual funds have risen from \$5.2 trillion to \$12.2 trillion. Yet the staggering economies of scale that characterize money management have been largely arrogated by fund managers to themselves, rather than shared with their fund shareholders. Consequently, despite a more than doubling of the asset base, expenses incurred by mutual fund investors have actually *risen* substantially during this period—by a staggering 81%—from \$48 billion to \$87 billion.¹

Result: Since 1999, fund investors have paid their money managers some \$840 billion—when 2014 ends, almost \$1 trillion. That drag on returns has helped to create an enormous dent in the returns that fund investors earn. Those costs are largely responsible for the seeming anomaly that the returns earned by actively-managed equity funds have fallen well short of the returns earned by passively-managed (and largely low-cost) index funds.

How is it possible that fund managers were motivated to enrich themselves at the expense of their own shareholders to whom they owe a fiduciary duty? The major factor, in my view, is that the one-time “mom-and-pop” industry of \$4 billion that I joined in 1951—relatively small management companies, largely owned and controlled by investment professionals—became the largest pool of assets in our nation, now overseeing some \$15 trillion of investor assets (including money market funds).

¹ Data source: Investment Company Institute Fact Book, 2014. The ICI expense table is entitled, incorrectly, “Expenses Incurred by Mutual Fund Investors Have *Declined* Substantially . . .” But expenses have actually increased by 81%. It is expense *ratios* that have declined, but not total expenses. Further, more than one-half of the drop in expense ratios has been created, not by managers selflessly cutting their fees, but by the explosive rise in index funds, now almost one-third of all equity fund assets. The expense ratios of actively-managed equity funds averaged about 0.87% in 2013, vs. the 0.74% reported by the ICI. For what it’s worth, the average weighted expense ratio in 1950 was 0.60, at a time when fund assets were but \$2.5 billion and total expenses of all funds combined were only \$15 million!

As the mutual fund industry became bigger, then big, and then the biggest single pool of investments in our nation, these small, closely controlled management companies of yore began to focus on “the bottom line,” i.e., their own profitability. In 1958, catastrophically, the U.S. Court of Appeals, 9th Circuit, effectively allowed management companies to “go public,” and a spate of initial public offerings (IPOs) quickly followed. Soon, giant U.S. and international financial conglomerates began to acquire these now-highly-profitable fund management companies. Today, among the 50 largest management companies, only ten remain privately owned (including Vanguard). 40 are publicly held, 10 directly by outside shareholders, and 30 by financial conglomerates.

The mutual fund industry has lost its way. That’s my view! But this critical analysis of the mutual fund industry is not mine alone. Hear this from another investor, David F. Swensen, Chief Investment Officer of Yale University, a man who has produced one of the most impressive investment records of the modern era, and who also has an impeccable reputation for character and intellectual integrity.:

The fundamental market failure in the mutual fund industry involves the interaction between sophisticated, profit-seeking providers of financial services and naïve, return-seeking consumers of investment products. The drive for profits by Wall Street and the mutual fund industry overwhelms the concept of fiduciary responsibility, leading to an all too predictable outcome: . . . the powerful financial services industry exploits vulnerable individual investors . . . The ownership structure of a fund management company plays a role in determining the likelihood of investor success . . .

Saving for Retirement

The central question facing the future welfare of America’s retirees is: “Are we saving enough?” First of all, fully one-third of our 122.5 million U.S. households have *no* retirement plan except Social Security—that’s 40 million families. (See **Exhibit 2**.) Second, most of the rest of us who have IRAs or corporate DC plans (or both) have accumulated savings that, truth told, are grossly inadequate to the task. In fact, according to the Center for Retirement Research at Boston College, the average balances of those of us nearing retirement (age 55-64) come to just \$120,000.

Exhibit 2: U.S. Retirement Plan Ownership

	Percentage	Millions of Households
Did not have IRA or employer-sponsored retirement plan	33%	40.4
Had IRA and employer-sponsored retirement plan	32%	39.2
Had employer-sponsored retirement plan only	29%	35.5
Had IRA only	6%	7.4

Sources: Investment Company Institute and U.S. Census Bureau.

Think of it this way: What amount of annual income would \$120,000 produce today? The yield on stocks is about 2%; the yield on stock mutual funds averages only about 1%. (Those excessive investment expenses take their toll.) The yield on a portfolio of U.S. Treasury and investment-grade corporate bonds is around 3%. Combine these yields, even haphazardly, and the yield on a balanced portfolio is something like 2%. On \$120,000, that's \$2,400 a year, or \$200 a month. Better than nothing, but not really *enough*.

But \$120,000 is merely the *average* accumulation for those of us nearing retirement. For the top quintile of households, the accumulation averages \$450,000. For the bottom quintile, the accumulation is but \$18,000—likely to produce income of about \$30 per month. Yes, most experts believe that a 4 % annual withdrawal rate (let's say 2% from income and 2% from capital) is likely to be sustainable over a retiree's lifetime. They're probably right. *Probably*.

At this hearing, I expect you'll hear from some experts who will argue that "all is well" for our retirement system that gives investors such a wide range of choices. An ICI survey, for example, suggests that those in their 60s have account balances averaging \$147,600 (\$239,000 for those who have been participating in their firm's plan for 30 years or more). But the ICI survey covers only "consistent participants" in 401(k) plans—those who have accumulated plan balances each year since 2007—so it hardly belies the \$120,000 average balance reflected in the Boston College survey.

Are We Adequately Prepared?

The average retirement balance for investors at or near retirement age then ranges from \$120,000 for *all* plan holders to \$147,600 for *consistent plan participants*. The answer to the question “Are we saving enough for retirement?” is, unequivocally, “No.”

And yet fund industry advocates (including the ICI) seem rather sanguine about today’s retirement readiness, claiming, “Contrary to conventional wisdom, most Americans are properly preparing for retirement.” Given that “most” could mean as few as 51% of households, this odd formulation would be true even if 49% were totally unprepared.

ICI presents data from four different studies, two of which support broad retirement readiness. One of these two studies tells us that 71% of households are prepared for retirement, the other avers that 84% are prepared. But the ICI also tells us that fully 33% of U.S. households have *no* employer-sponsored retirement plans whatsoever. Thus you would be unwise to give much credence to those two surveys.

The other two studies of this subject considered by the ICI suggested between 48% and 57% of households are estimated to be prepared for retirement. These data clearly reaffirm what we see in the modest retirement accumulations cited earlier for those at or near retirement. Indeed, a Federal Reserve Board study concludes that only about one-fourth of individuals appear to be planning for their own retirement.

If one presumes that common sense and objective reality trump speculative data from surveys making a plethora of mind-boggling assumptions, *then of course we are not saving enough*. David Brooks, columnist for *The New York Times*, describes the reality:

The people who created this country built a moral structure around money. The Puritan legacy inhibited luxury and self-indulgence. Benjamin Franklin spread a practical gospel that emphasized hard work, temperance and frugality.

Over the past 30 years, much of that has been shredded. The social norms and institutions that encouraged frugality and spending what you earn have been undermined. The institutions that encourage debt and living for the moment have been strengthened . . . the most rampant

decadence today is financial decadence, the trampling of decent norms about how to use and harness money.

[This] transformation has led to a stark financial polarization. On the one hand, there is ... the investor class. It has tax-deferred savings plans, as well as an army of financial advisers. On the other hand, there is the lottery class, people with little access to 401(k)'s or financial planning but plenty of access to payday lenders, credit cards and lottery agents.

Facing the Facts

Let's face the facts: in 2013, twenty percent of our households received income below \$20,599. (In current dollar terms, slightly *below* the \$20,633 figure for 1970—an astonishing 33 years of stagnation.) Can you imagine trying to save for your retirement when you earn \$20,000 a year *before taxes*? For the record, our households in the fifth percentile (earning more than 95% of U.S. households) earned \$191,156 in 2012, up from 28,950 in 1975, which equals \$138,122 in 2012 dollars, a *real* increase of almost 40%.

So for those in David Brooks' "lottery class," the *only* way to approach adequacy in retirement security is to enhance Social Security (or some new supplemental federal program) for those at the lowest income levels in our society. Given the constraints of today's federal budget deficit, this will not be easy to accomplish.

For the "investor class," those at the very top of the income ladder need little additional support for their retirement. At lower levels, greater tax incentives for retirement savings would help, but a tax-*credit* would be a wiser policy than a tax-*deduction*, for it would limit further reductions in tax revenues by the federal government due to tax-favored retirement plans. That loss in revenue totaled an estimated \$164 billion in 2012 alone.

It is not at all clear that public policy should continue to encourage retirement savings for our wealthiest citizens, who have the resources (and more!) to prepare for retirement without needing tax incentives. But we must be careful in how we handle this politically charged issue. It stands to reason that in order to gain tax advantages for themselves, employers (especially in small- and medium-sized companies) may well be more likely to provide 401(k) plans for their employees, surely a social good.

A Federal Standard of Fiduciary Duty for Money Managers

Finally, I offer one simple, essential principle that is required to underscore the more shareholder-oriented (as opposed to manager-oriented) mutual fund industry that I envision: a federal standard of fiduciary duty for our nation's institutional money managers (including, of course, mutual fund managers).² Such a standard of fiduciary duty for institutional money managers would include:

1. A requirement that all fiduciaries must act solely in the long-term interests of their beneficiaries.
2. An affirmation by government that an effective shareholder presence in all public companies is in the national interest.
3. A demand that all institutional money managers should be accountable for the compulsory exercise of their proxy votes, in the sole interest of their shareholders.
4. A demand that any ownership structure of managers that entails conflicts of interest be eliminated.

It is a curious and, finally, unpalatable fact that so far the subject of fiduciary duty has touched just about every aspect of investing *except* money management. For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, under section 913(g)(1), enables the SEC to “promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers ... shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.”

The omission of mutual fund managers (and other institutional money managers) was clearly deliberate. For section 913(g)(2) explicitly states “the Commission shall not ascribe a meaning to the term ‘customer’ that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.”

The Department of Labor (DOL) has also ducked on the issue of fiduciary duty for fund managers, limiting their attempt to broaden the standards applied to retirement plans to include financial advisers to the plans (i.e., firms offering investment advice to individual plan participants and employee

² While a fiduciary standard is not required under the Investment Company Act of 1940, the Act's preamble makes it clear that honoring the fiduciary standard is expected. To wit, Section 1(b)(2) states that mutual funds must be “organized, operated, and managed” in the interests of their shareholders rather than in “the interests of [their] directors, officers, investment advisers ... underwriters, brokers, or dealers.”

retirement plans). The DOL first made this proposal in 2010. At that time the fiduciary standard applied only to registered investment advisers (RIAs).

But even without proposing that fund investment managers be subject to the same standard, the DOL proposal has been the victim of fierce criticism and long delays, and still awaits even more meetings with the various interest groups. What's more, the SEC has warned the DOL *not* to implement its rule until the commission advances its own rule on a uniform fiduciary duty standard on *retail investment advice*.

I cannot fathom how this crabbed, narrow application of a fiduciary standard can ignore the most important element in the entire retirement plan system—the money managers who essentially run the funds that compose not only the entire universe of defined contribution plans, but the entire universe of managers who oversee virtually all of the savings of American citizens who have entrusted the care of their assets to their trustees (whether we call them by that name or not).

Fiduciary duty for all individuals and institutions who touch Other Peoples Money is an idea whose time has come. The financial industry and its lobbyists had better get prepared for it.

Where Do We Go from Here?

Look, members of the Senate Finance Committee: DC plans (including IRAs) are the *only* realistic alternative for investors seeking to achieve a comfortable retirement. But we must demand significant (some might say, radical) changes in the structure of DC plans, and in helping investors to get their money's worth out of each dollar they invest. There are, in fact, some notable examples of DC plans that work, and that work with great efficiency in helping employees accomplish their financial goals.

The most obvious example—which strikes close to home here in Washington, DC—is the Thrift Savings Plan (TSP). It is large: \$385 billion, among the 25 largest pools of institutional money management. It is, well, cheap, with an annual expense ratio of less than 0.03% (three basis points). It is largely indexed: 100% of its long-term assets—some \$212 billion—are composed of four index funds. (The remaining \$172 billion is invested in a money-market-like account composed of U.S. government securities specially issued to TSP.)

TSP is generous. Each participant may invest up to \$17,500 per year in the plan, and there is an automatic deduction of 3% of salary unless the participant opts out. An additional matching contribution of up to 4% is also available. Yes, members of the committee; you are all eligible to participate in the Federal Employees Retirement System. You have a fine DC option right at your fingertips.

And, I should add, so have I. At the beginning of my career at Wellington Management Company in 1951, the company provided a defined contribution pension plan in which each employee's compensation was set aside in Wellington Fund, a balanced (bond/stock) mutual fund, even then among the lowest-cost funds in the industry. Yes, as times and circumstances changed, the provisions of the plan changed, and in recent years our Vanguard Retirement Savings Plan (RSP) has provided a company contribution of 10% of base compensation, plus 5.7% of compensation in excess of the Social Security wage base. The company also matches, dollar for dollar, up to the first 4% of an employee's voluntary contribution.

Yes, this is an extraordinarily generous DC plan, but it was designed to obviate the need for a DB plan. And, as a plan participant for 63 years now—still focused importantly on Wellington Fund, but otherwise relying largely on Vanguard index funds—my retirement plan is the largest asset in my estate. *The magic of long-term compounding of investment returns, absent the tyranny of long-term compounding of investment costs, works!*

* * *

DC plans can work—and they *must* work. DC plans already are the mainstay of our nation's retirement system, and they become more important with each passing day. But these one-time *thrift plans* must take on the best attributes of *retirement plans*. They must be restructured, entailing the lowest possible cost burdens on investors and operated by managers that are held to a federal standard of fiduciary duty. All of these improvements are within our reach, and it is high time we begin the long march toward their accomplishment.

Chapter 7

America's Retirement System

Too Much Speculation, Too Little Investment

It is within our reach to move capitalism in a direction that is more wealth creating, more sustainable, less crisis-prone, and more legitimate than the “headwinds” capitalism we have today . . . to “pension fund capitalism.” . . . It requires the redesign of pension fund organizations so that they themselves become more effective and hence more productive stewards of the retirement savings of young workers and pensioners alike.

—Keith Ambachtsheer

An Introductory Note

We don't usually think of the retirement systems of our nation as, well, speculative. But, in fact, our defined benefit (DB) pension plans entail two distinct kinds of speculation. First, our pension managers are hardly free of the same counterproductive biases and emotions as their

individual investor counterparts. Second, the defined benefit payments promised by pension plans to our retired citizens are, in effect, based on speculation as to whether today's highly optimistic projected investment returns will actually be earned. If not, the providers of these plans will prove to have made too little investment, and corporations will face huge shortfalls in funding.

Corporate sponsors of private pensions would have to raise their annual contributions to fund the plans—no mean task for corporations now aggressively seeking to slash costs in order to increase the earnings they report to their shareholders. For our state and local governments—now struggling to hold down costs—future budgets calling for higher annual plan contributions would not be popular with taxpayers. Even the necessary changes to Social Security are a matter of speculation. Can we rely on a Congress that is at an impasse—conflicted by partisan wrangling and gridlock—to ensure that future payments will continue to be made at present levels to retirees from this backstop of our national retirement system?

In our defined contribution (DC) plans, too many individual plan participants have behaved much like speculators. To name the major faults of these retirement plan investors: excessive turnover of their fund investments; betting on the selection of funds that are expected to outperform their peers in the future; gambling that fund managers can, despite their excessive costs, outpace the market; and failing to adequately diversify by making ill-considered asset allocation choices. It turns out that individual investors make the same mistakes in their retirement savings plans as they do in their personal investment portfolios. (How could one expect an individual investor to have two different mindsets?) Together, those particular chinks in the armor of sound long-term investment combine to result in the biggest speculation of all: the odds that participants will earn returns on their savings plans that will be adequate to ensure their comfortable retirement.

This chapter discusses the “Seven Deadly Sins” of the retirement system, and five of its obvious flaws. Where there are sins and flaws, I note, there are opportunities to fix them, including my proposal to create a Federal Retirement Board to oversee the diffuse and complex elements of our multiple variety of defined contributions plans—IRAs, 401(k) thrift savings plans, and 403(b) plans offered by nonprofit

organizations—and focus on serving the needs of our nation's citizen/investors.

I conclude the chapter with some provocative ideas on “The New Pension Plan,” suggesting a redesign of today's system in the interests of the investors who are saving for their retirements. I present recommendations and simplifications, including reducing Wall Street's over-sized role in today's system, and focusing not only on investment risk, but longevity risk as well. These reforms should serve to increase in the long-term wealth accumulations by DB plans, by DC plans, and by IRA investors. In all, these reforms would move us away from today's culture in which speculation is rife, and far closer to a culture of long-term investing.

Today our nation's system of retirement security is imperiled, headed for a serious train wreck. That wreck is not merely waiting to happen; we are running on a dangerous track that is leading directly to a serious crash that will disable major parts of our retirement system. Federal support—which, in today's world, is already being tapped at unprecedented levels—seems to be the only short-term remedy. But long-term reforms in our retirement funding system, if only we have the wisdom and courage to implement them, can move us to a better path toward retirement security for our nation's families.

The Inadequacy of Our National Savings

Underlying the specific issues affecting our retirement plan system is that our national savings are inadequate. We are directing far too little of those savings into our retirement plans in order to reach the necessary goal of self-sufficiency. “Thrift” has been *out* in America; “instant gratification” in our consumer-driven economy has been *in*. As a nation, we are not saving nearly enough to meet our future retirement needs. Too few citizens have chosen to establish personal retirement accounts such as IRAs and 403(b)s, and even those who have established them are funding them inadequately and only sporadically. These investors and potential investors are, I suppose, speculating that their retirement will be fully funded by some combination of Social Security, their pensions, their unrealistically high expectations for future investment returns, or (as a last resort) from their families.

Broadly stated, we Americans suffer from a glut of spending and a (relative) paucity of saving, especially remarkable because the combination is so counterintuitive. Here we are, at the peak of the wealth of the world's nations, with savings representing only about 3 percent of our national income. Among the emerging nations of the world—with per capita incomes less than \$5,000 compared to our \$48,000—the saving rate runs around 10 percent, and in the developed nations such as those in Europe, the savings rate averages 9 percent, with several major nations between 11 and 13 percent. Our beleaguered pension system is but one reflection of that shortfall.

Box 7.1

Rebalancing the Financial Priorities of Our Citizens

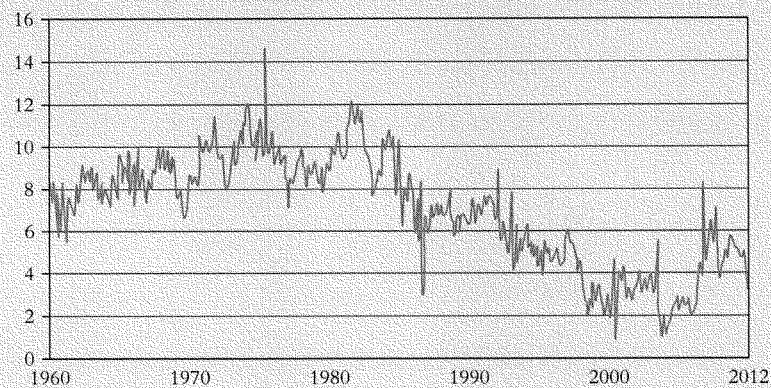
The failure of American citizens to adequately fund their retirement plans is but one manifestation of our national preference for spending over saving. "I'll enjoy the consumer goods I can buy today (and even borrow from the future so I can enjoy them now) and worry about far off needs later on." As Scarlett O'Hara famously said, "I'll worry about it tomorrow." As if tomorrow will never come.

Paradoxically, our economy depends on consumer spending. Some 70 percent of our gross domestic product (GDP) is accounted for by spending. Not only on the daily necessities—food, shelter, medical care—but on luxury goods that represent "conspicuous consumption." I don't argue with that as such, but by shortchanging our needs for retirement, our lives will not be as we might expect when the time comes. We must save more (and borrow less), for in the long run, a healthy U.S. economy depends on the financial stability of our households. Yet our household savings rates, while they have risen during the recent recession, are far below historic norms.

As the following exhibit shows, from the 1960s through the 1980s, household savings ranged around 9 percent of income.

Then the rate began a gradual decline all the way down to the 2 percent range—a 75 percent decline—during 2000–2007, recovering to about 6 percent thereafter. But the most recent report shows a U.S. savings rate at just 3 percent.

U.S. Household Savings Rates (1960–2012)



Paradoxically, although we are one of the world's wealthiest nations (average household income of \$48,000), we save relatively less than the citizens of most others. Household wealth in Germany is similar to ours (\$44,000), but their savings rate is 11 percent. (Other major European nations average about 9 percent.) And even in the world's emerging economies, where annual household incomes run from \$1,500 (India) to \$5,200 (China), savings rates can easily run far higher than ours.

What's to be done? Better investor education; more efficient regulation; substantial protection against financial fraud for our citizens (the new Consumer Financial Protection Bureau, for example); greater tax incentives for our less wealthy brethren to save; and more rigorous credit standards for borrowers. More profoundly, we must move over time toward an economy less dependent on short-term spending and more dependent on long-term saving.

“The Seven Deadly Sins”

Let’s now move from the general to the particular, and examine some of the major forces in today’s retirement systems that have been responsible for the dangerous situation we now face.

Deadly Sin 1: Inadequate Retirement Accumulation

The modest median balances so far accumulated in 401(k) plans make their promise a mere shadow of reality. At the end of 2009, the median 401(k) balance is estimated at just \$18,000 per participant. Indeed, even projecting this balance for a middle-aged employee with future growth engendered over the passage of time by assumed higher salaries and real investment returns, that figure might rise to some \$300,000 at retirement age (if these assumptions prove correct). While that hypothetical accumulation may look substantial, however, it would be adequate to replace less than 30 percent of preretirement income, a help but hardly a panacea. (The target suggested by most analysts is around 70 percent, including Social Security.)

Part of the reason for today’s modest accumulations are the inadequate participant and corporate contributions made to the plans. Typically, the combined contribution comes to less than 10 percent of compensation, while most experts consider 15 percent of compensation as the appropriate target. Over a working lifetime of, say, 40 years, an average employee, contributing 15 percent of salary, receiving periodic raises, and earning a real market return of 5 percent per year, would accumulate \$630,000. An employee contributing 10 percent would accumulate just \$420,000. If those assumptions are realized, this would represent a handsome accumulation, but substantial obstacles—especially the flexibility given to participants to withdraw capital, as described below—are likely to preclude their achievement. (In both cases, with the assumption that every single contribution is made on schedule—likely a rare eventuality.)

Deadly Sin 2: The Stock Market Collapse

One of the causes of the train wreck we face—but hardly the only cause—was the collapse of our stock market, on balance taking its value

from \$17 trillion capitalization at the October 2007 high in U.S. stocks, to a low of \$9 trillion in February 2009. Much of this stunning loss of wealth has been recovered in the rally that followed, and as 2012 begins, the market value totals \$15 trillion. Nonetheless, our nation's DB pension plans—private and government alike—are presently facing staggering deficits. And the participants in our DC plans—thrift plans and IRAs alike—have accumulations that fall short of what they will need when they retire.

Deadly Sin 3: Underfunded Pensions

Our corporations have been funding their defined benefit (DB) pension plans on the mistaken assumption that stocks would produce future returns at the generous levels of the past, raising their prospective return assumptions even as the stock market reached valuations that were far above historical norms. And the DB pension plans of our state and local governments seem to be in the worst financial condition of all. (Because of poor transparency, inadequate disclosure, and nonstandardized financial reporting, we really don't know the dimensions of the short-fall.) The vast majority of these plans are speculating that future returns will bail them out.

Currently, most of these DB plans are assuming future annual returns in the 7.5–8 percent range. But with stock yields at 2 percent and, with the U.S. Treasury 30-year bond yielding 3 percent, such returns are a pipedream. It is ironic that in 1981, when the yield on the long-term Treasury bond was 13.5 percent, corporations assumed that future returns on their pension plans would average just 6 percent, a similarly unrealistic—if directly opposite—projection as 2012 begins.

Corporations generate earnings for the owners of their stocks, pay dividends, and reinvest what's left in the business. In the aggregate, the sole sources of the long-term returns generated by the equities of our businesses should provide investment returns at an annual rate of about 7–8 percent per year over the next decade, including about 2 percent from today's dividend yield and 5–6 percent from earnings growth. Similarly, bonds pay interest, which is the sole source of their long-term returns. Based on today's yield, the aggregate return on a portfolio of corporate and government bonds should average about 3.5 percent.

A portfolio roughly balanced between these two asset classes might earn a return in the range of 5–6 percent during the coming decade.

Deadly Sin 4: Speculative Investment Options

A plethora of unsound, unwise, and often speculative investment choices are available in our burgeoning defined-contribution (DC) plans. Here, individuals are largely responsible for managing their own tax-sheltered retirement investment programs—individual retirement accounts (IRAs) and defined-contribution pension plans such as 401(k) thrift plans that are provided by corporations, and 403(b) savings plans provided by nonprofit institutions. Qualified independent officials of their employers seem to provide little guidance. What’s more, they often focus on spurious methodology that is too heavily based on *historical* data, rather than the timeless *sources of returns* that actually shape the long-term investment productivity of stocks and bonds, misleading themselves, their firms, and their fellow employees about the hard realities of investing.

Deadly Sin 5: Wealth-Destroying Costs

The returns in our stock market—whatever they may turn out to be—represent the *gross* returns generated by the publicly owned corporations that dominate our system of competitive capitalism (and by investment in debt obligations). Investors who hold these financial instruments—either directly or through the collective investment programs provided by mutual funds and defined benefit pension plans—receive their returns only *after* the cost of acquiring them and then trading them back and forth among one another. Don’t forget that our financial system is a greedy one, consuming from 1 to 2 percentage points of return, far too large a share of the returns created by our business and economic system. So we must recognize that individual investors and pension funds alike will receive only the net returns, perhaps in the 4–5 percent range, after the deduction of those costs. To significantly enhance that return, as shown in Box 7.2, less conventional portfolios using “alternative” investments will have to deliver returns that far exceed their own historical norms. To say the least, that is one more speculative bet.

Box 7.2**The Elusive 8 Percent**

With reasonable expectations for a nominal return of roughly 7 percent on stocks over the coming decade, and, with somewhat more assurance, a return of roughly 3 percent on bonds, a traditional 65/35 stock/bond policy portfolio of a defined benefit (DB) pension plan might reasonably expect to earn a 5.5 percent annual return. Given the cost efficiencies in managing and administering portfolios with substantial assets, I assume a cost of 1 percent, bringing the return to 4.5 percent. Let's be generous and call it 5 percent.¹

So is that the return that our corporate DB plans are projecting? No, it is not. The typical return projection is 8 percent, with a few plans—corporate and local government alike—as high as 9 percent and a few as low as 7 percent, or even slightly less. (Berkshire Hathaway is using a 6.9 percent assumption.) Where do these estimates come from? Well, here is what one large corporation tells us: “We consider current and expected asset allocations, as well as *historical* and expected returns on various categories of plan assets . . . evaluating general market trends as well as key elements of asset class returns such as expected earnings growth, yields and spreads. Based on our analysis of future expectations of asset performance, *past return results*, and our current and expected asset allocations, we have assumed an 8.0 percent long-term expected return on those assets” (italics added, General Electric Annual Report, 2010). Such disclosure has become sort of annual-report boilerplate.

All well and good, but, as they say, let's add some “granularity” (a word I don't much care for), making some assumptions

(Continued)

¹While the returns that I describe are measured in *nominal* terms (current dollars), even an inflation rate of only 2 percent would result in a *real* return of just 3 percent.

that are arbitrary but not unrealistic. The table below shows one version of how various markets and asset-class managers must perform in order for a pension plan to reach that elusive goal.

A Template for DB Returns During the Coming Decade

(2 + 3)				(4 - 5)		
	1.	2.	3.	4.	5.	6.
		Projected	Value	Adjusted	Less	
Class	Allocation	Annual	Added	Annual	Investment	Net
		Return	by	Return	Costs	Return
			Managers			
Traditional Policy Portfolio						
Equities	40%	7.0%	+2.5%	9.5%	-1.0%	8.5%
Bonds	30	3.0	+0.5	4.0	-0.5	3.5
Alternative Investments						
Venture						
Capital	10	12.0	+3.0	15.0	-3.0	12.0
Hedge						
Funds	20	12.0	+3.0	15.0	-3.0	12.0
Total	100%	7.3%	2.2%	9.5%	-1.5%	8.0%

In effect, I present in the chart the very analysis that at least some corporations use—yet without their disclosure of the specific numbers they use. Here's the Exxon Mobil explanation for the process that underlies the corporation's expected return assumption of 7.5 percent for its pension plan: "a forward-looking, long-term return assumption for each asset class, taking into account factors such as the expected return for each." (Note that the firm totally ignores the costs of investing.)

Now let's consider how realistic the data in the table might be. First, the stock and bond returns are fully consistent with the reasonable expectations cited earlier. The returns for venture capital are generous but perhaps not unreasonable. But the required returns for hedge funds are far above historical norms. As to the value added by managers, my long experience tells me

that it is extremely unlikely that any manager can possibly deliver the 3 percentage points of excess return that are required. Good luck in picking one in advance. What's more, for DB plan managers as a group—competing with one another—zero Alpha is the expected outcome. (In fact, with the typical costs that I've assumed, pension managers will, in the aggregate, produce *negative* Alpha.) Even if our asset class returns for equities and bonds are realized, venture capital and hedge funds would have to earn returns that are far above historical norms. If those asset classes fail to do so, the actual realized return for this example would fall by 2 percentage points, to 6 percent per year.

Mark your calendars for 2022, 10 years hence, and see who's made the best estimate. For me, subjectively, even 6 percent is an ambitious goal. (The 10-year U.S. Treasury bond is presently yielding less than 2 percent, the 30-year Treasury about 3 percent.) And even if that 6 percent return is in fact achieved, the financial implications of the cumulative deficit from the 8 percent assumption will be staggering, particularly when today's cumulative deficit in corporate pensions is almost \$500 billion. By then, I hope, our corporations will be required to report the *actual* 10-year returns of their DB plans, a disclosure that, absurdly, has never been mandated.

Deadly Sin 6: Speculation in the Financial System

Speculation is rife throughout our financial system (and our world). As Chapter 1 discusses, high stock market volatility; risky, often leveraged, derivatives; and extraordinary turnover volumes have exposed the markets to mind-boggling volatility. As I note earlier, some of this hyperactivity is necessary to provide the liquidity that has been the hallmark of the U.S. financial markets. But trading activity has grown into an orgy of speculation that pits one manager against another—one investor (or speculator) against another—a “paper economy” that has, predictably, come to threaten the real economy where our citizens

save and invest. It must be obvious that our present economic crisis was, by and large, foisted on Main Street by Wall Street—the mostly innocent public taken to the cleaners, as it were, by the mostly greedy financiers.

Deadly Sin 7: Conflicts of Interest

Conflicts of interest are rife throughout our financial system: Both the managers of mutual funds that are held in corporate 401(k) plans and the money managers of corporate pension plans face potential conflicts when they hold the shares of the corporations that are their clients. It is hardly beyond imagination that when a money manager votes proxy shares against a company management's recommendation, it might not sit well with company executives who select the plan's provider of investment advice. (There is a debate about the extent to which those conflicts have actually materialized.)

But there's little debate in the mind of Lynn Turner, former chief accountant of the SEC: "Asset managers who are charging corporations a fee to manage their money have a conflict in that they are also trying to attract more money which will increase their revenues, and that money often comes from companies who set up retirement accounts for their employees. There is not disclosure, from the asset manager to the actual investors whose capital is at risk, of the amount of fees they collect from the companies whose management they are voting on. It appears the institutional investors (including managers of mutual funds) may vote their shares at times in their best interests rather than the best interests of those whose money they are managing."

In trade union plans, the conflicts of interest are different, but hardly absent. Insider dealing among union leaders, investment advisers, and money managers has been documented in the press and in the courts. In corporate defined benefit pension plans, corporate senior officers face an obvious short-term conflict between minimizing pension contributions in order to maximize the earnings growth that market participants demand, versus incurring larger pension costs by making timely and adequate contributions to their companies' pension plans in order to assure long-term security for the pension benefits they have promised

to their workers. These same forces are at work in pension plans of state and local governments, where the reluctance (or inability) to balance budgets leads to financial engineering—rarely disclosed—in order to justify future benefits.

Extracting Value from Society

Together, these Seven Deadly Sins echo what I've written at length about our absurd and counterproductive financial sector. Here are some excerpts regarding the costs of our financial system that were published in the Winter 2008 issue of *Journal of Portfolio Management*: “. . . mutual fund expenses, plus all those fees paid to hedge fund and pension fund managers, to trust companies and to insurance companies, plus their trading costs and investment banking fees . . . have soared to all-time highs in 2011. These costs are estimated to total more than \$600 billion. Such enormous costs seriously undermine the odds in favor of success for citizens who are accumulating savings for retirement. Alas, *the investor feeds at the bottom of the costly food chain of investing*, paid only *after* all the agency costs of investing are deducted from the markets' returns. . . . Once a profession in which business was subservient, the field of money management has largely become a business in which the profession is subservient. Harvard Business School Professor Rakesh Khurana is right when he defines the standard of conduct for a true professional with these words: “*I will create value for society, rather than extract it.*” And yet money management, by definition, extracts value from the returns earned by our business enterprises.”

These views are not only mine, and they have applied for a long time. Hear Nobel laureate economist James Tobin, presciently writing in 1984: “. . . we are throwing more and more of our resources into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity, a ‘paper economy’ facilitating speculation which is short-sighted and inefficient.” (In validating his criticism, Tobin cited the eminent British economist John Maynard Keynes. But he failed to cite Keynes's profound warning, cited earlier, that business enterprise has taken a back seat to financial speculation.) The multiple failings of our flawed financial sector are jeopardizing not only the

retirement security of our nation's savers but also the economy in which our entire society participates.

Our Retirement System Today

The present crisis in worker retirement security is well within our capacity to measure. The picture it paints is not a pretty one:

Social Security. While it is the massive backstay of our nation's retirement system, its future is speculative. Today, we can only guess whether Congress will continue to support its deficits. Or will the grit and resolve to make the simple changes required to assure its long-term solvency prevail?² All it would take is some combination of a gradual increase in the maximum income level for wage earners paying into the plan; a change from the wage-increase-based formula for increasing benefits to an inflation-based formula; a gradual increase in the retirement age to, say, 69; and a modest means test, limiting retirement payouts to those citizens with considerable wealth. (If Congress wishes to appoint me as the czar to implement these reforms, I'd be glad to accept the challenge.)

Defined Benefit Plans. Until the early 1990s, investment risk and the longevity risk of pensioners (the risk of outliving one's resources) were borne by the defined benefit (DB) plans of our corporations and our state and local governments, the pervasive approach to retirement savings outside of that huge national DB plan we call Social Security. But in the face of a major shift away from DB plans in favor of DC plans, DB growth has essentially halted. Largely because of the stock market's sharp decline, assets of corporate pension plans have declined from \$2.1 trillion as far back as 1999 to an estimated \$1.9 trillion as 2012 began. As noted at the outset, these plans are now severely underfunded. For the companies in the Standard & Poor's 1500 Index, pension plan

²If Congress does nothing, however, Social Security will continue. But according to a recent report, payments to retirees would fall to about 75 percent of today's levels by 2033.

assets to cover future payments to retirees face a deficit of almost \$500 billion as 2012 begins. The deficits in state and local pension plans have been estimated at over \$4 *trillion*, even as promises for higher future benefits continue to rise.

This deficit is reflected in the sharp drop in funding ratios of the pension plans (plan assets as a percentage of plan liabilities). The funding ratios for the giant corporations in the S&P 500 have fallen from 105 percent in 2007 to 80 percent in 2011; the ratio for public plans from 95 percent to 75 percent. What's more, the corporate plans show little sign of improvement; their average investment return of 4.4 percent in 2011 was barely one-half of their typical 8 percent return assumption. With bond yields in early 2012 remaining near their historic lows, only highly aggressive returns earned by the plans' equities and alternative investments will bail out these pension plans, a most speculative assumption, as shown in Box 7.2. If that desideratum does not happen, our companies will incur far larger pension expenses.

The Pension Benefit Guaranty Corporation. This federal agency, responsible for guaranteeing the pension benefits of failing corporate sponsors is itself faltering, with a \$14 billion deficit in mid-2011. Early in 2008—just before the stock market's collapse—the agency made the odd decision to raise its allocation to diversified equity investments to 45 percent of its assets, and add another 10 percent to “alternative investments,” including real estate and private equity. The decision to double the PBGC's equity participation came at what turned out to be the worst possible moment. (We don't yet know how that change worked out.) The fact is that the PBGC will ultimately require more funding if it is to meet its obligations. We don't know whether or how the issue will be resolved; we can only speculate.

Defined Contribution Plans. DC plans are gradually replacing DB plans, a massive transfer of *investment risk and return* as well as the *longevity risk* of retirement funding from business enterprises to their employees. While DC plans have been available to provide the benefits of tax-deferral for retirement savings for well

over a half-century,³ it has only been with the rise of employer thrift plans such as 401(k)s and 403(b)s, beginning in 1978, that they have been widely used to accumulate retirement savings. The growth in DC plans has been remarkable. Assets totaled \$500 billion in 1985; \$1 trillion in 1990; \$3 trillion in 2000; \$4.5 trillion in 2010. The 401(k) and 403(b) plans dominate this total, with respective shares of 67 percent and 21 percent, or 88 percent of the DC total.

Individual Retirement Accounts. IRA assets presently total about \$4.7 trillion, about the same as the \$4.8 trillion total in 2007, before the stock market crash. Mutual funds (now some \$2 trillion) continue to represent the largest single portion of these investments. Yet with some 49 million households participating in IRAs, the average balance is but \$55,000, which at, say, a 5 percent average return, would provide but \$2,750 per year in retirement income for a household, a nice but far-from-adequate increment in a case where the wage-earner retired today. Younger workers with such a balance would of course see it grow remarkably over time. For example, such a balance assuming a 6 percent future return on the account, would grow to \$565,000 over the next 40 years.

Focusing on 401(k) Retirement Plans

Defined contribution pension plans, as noted earlier, have gradually come to dominate the private retirement savings market, and that domination seems certain to increase. Further, there is some evidence that DC plans are poised to become a growing factor in the public plan market. The federal employees' Thrift Savings Plan is the largest single factor. With assets of about \$250 billion, it has operated as a defined

³I have been investing 15 percent of my annual compensation in the DC plan of the company (and its predecessor) that has employed me ever since July 1951, when I first entered the work force. I can therefore give my personal experience that tax-deferred defined-contribution pension plans, added to regularly; reasonably allocated among stocks and bonds; highly diversified, managed at low cost; and compounded over a long period, are capable of providing wealth accumulations that, after my 61 years of participation, seem little short of miraculous.

contribution plan since its inception in 1986. As 401(k) plans have come to dominate the DC market, mutual fund shares have come to dominate the 401(k) market. Assets of mutual funds in DC plans have grown from a mere \$35 billion in 1990 (9 percent of the total) to an estimated \$2.3 trillion in 2012 (53 percent).

Given the plight in which our defined benefit plans have found themselves, and the large (and, to some degree, unpredictable) bite that future funding costs will take out of corporate earnings, it is small wonder that what began as a gradual shift became a massive movement to defined contribution plans. Think of General Motors, for example, as a huge pension plan, now with perhaps \$94 billion of assets—and likely even larger liabilities—surrounded by a far smaller automobile business, operated by a company with a current stock market capitalization of just \$38 billion.

I would argue that the shift from DB plans to DC plans is not only an inevitable move, but a move in the right direction in providing worker retirement security. In this era of global competition, U.S. corporations must compete with non-U.S. corporations with far lower labor costs. So this massive transfer of the two great risks of retirement plan savings—investment risk and longevity risk—from corporate balance sheets to individual households will relieve pressure on corporate earnings, even as it will require our families to take responsibility for their own retirement savings. A further benefit is that investments in properly designed DC plans can be tailored to the specific *individual* requirements of each family—reflecting its prospective wealth, its risk tolerance, the age of its bread-winner(s), and its other assets (including Social Security). DB plans, on the other hand, are inevitably focused on the *average* demographics and average salaries of the firm's work force in the aggregate.

The 401(k) plan, then, is an idea whose time has come. *That's the good news.* We're moving our retirement savings system to a new paradigm, one that ultimately will efficiently serve both our nation's employers—corporations and governments alike—and our nation's families. *Now for the bad news:* Our existing DC system is failing investors. Despite its worthy objectives, the deeply flawed implementation of DC plans has subtracted—and subtracted substantially—from the inherent value of this new system. Given the responsibility to look after their own investments,

participants have acted contrary to their own best interests. Let's think about what has gone wrong.

A Deeply Flawed System

Since it has become the dominant force in pension funding, I now turn to the defined contribution plan. The major flaws that continue to exist in our 401(k) system (and, to some extent, in our IRA system) require radical reform. For our task is to give employees the fair shake that must be the goal if we are to serve the national public interest and the interest of investors. In addition to the shortfall in national savings illustrated in Box 7.1, the major problems in our retirement plan system that cry out for reform lie in the following five areas.

Too Much Flexibility. 401(k) plans, designed to fund retirement income, are too often used for purposes that subtract directly from that goal. One such subtraction arises from the ability of employees to borrow from their plans, and fully 20 percent of participants do exactly that. Even when—and if—these loans are repaid, investment returns (assuming that they are positive over time) would be reduced during the time that the loans are outstanding, a dead-weight loss in the substantial savings that might otherwise have been accumulated at retirement.

Even worse is the dead-weight loss—in this case, largely permanent—engendered when participants “cash out” their 401(k) plans when they change jobs or when their family circumstances change. The evidence suggests that fully 60 percent of all participants in DC plans who move from one job to another cash out at least a portion of their plan assets, using that money for purposes other than retirement savings. To understand the baneful effect of borrowings and cash-outs, just imagine in how much worse shape our beleaguered Social Security System would find itself if the contributions of workers and their companies were reduced by borrowings and cash-outs, flowing into current consumption rather than into future postretirement pay. It is not a pretty picture to contemplate.

Another kind of excess flexibility, clearly demonstrated during the recent recession, is the freedom given to corporations to modify,

suspend, or even abandon their employee retirement plans. Counterproductively, this means that the benefits of “dollar cost averaging” are often suspended during tough times, just when stock prices tend to be most attractive for long-term investors. The IRA situation, sadly, is even more flexible, for sticking to a regular payment schedule is totally at the option of the IRA owner, and withdrawals can be made easily, albeit subject to significant penalties.

Inappropriate Asset Allocation and Faulty Investment Selection. One reason that 401(k) investors have accumulated such disappointing balances is due to unfortunate decisions in the allocation of assets between stocks and bonds.⁴ While virtually all investment experts recommend a large allocation to stocks for young investors and an increasing bond allocation as participants draw closer to retirement, a large segment of 401(k) participants fails to heed that advice.

Nearly 20 percent of 401(k) investors in their 20s own zero equities in their retirement plan, holding, instead, outsized allocations of money market and stable value funds, options that are unlikely to keep pace with inflation as the years go by. On the other end of the spectrum, more than 30 percent of 401(k) investors in their 60s have more than 80 percent of their assets in equity funds. Such an aggressive allocation likely resulted in a decline of 30 percent or more in their 401(k) balances during the present bear market, imperiling their retirement funds precisely when the members of this age group are preparing to draw upon it.

Company stock is another source of unwise asset allocation decisions, as many investors fail to observe the time-honored principle of diversification. In plans in which company stock is an investment option, the average participant invests more than 20 percent of his or her account balance in company stock, an unacceptable concentration of

⁴These data are derived from a Research Perspective dated December 2008, published by the Investment Company Institute, the association that represents mutual fund management companies, collecting data, providing research, and engaging in lobbying activities.

risk. Those who are far too conservative, those who are far too “aggressive,” and those who bet the ranch (or a large part of it) on tying their careers to their retirement plan are all speculating about what the future holds, rather than true investing, diversifying those risks (but not market risk itself) away.

ERISA restricts a pension plan’s allocation in company stock to 10 percent of assets (still far too high a concentration for any individual equity). No similar restriction exists for 401(k) plans, although a recent Department of Labor regulation requires corporations to allow employees to diversify out of company stock after a certain period of time. Concerns about the concentration of assets in company stock, which can be exacerbated by employer matches issued in the form of company stock, led FINRA to issue an alert warning investors against this behavior. According to a 2009 study conducted by the Employee Benefit Research Institute, over one-half of employees having the option to invest in company stock do so. This concentration in a single asset puts employees in a precarious position where both their job and their life savings can be wiped out by shocks to a single company—a sort of “double jeopardy” that is extremely unwise.

Yet another form of speculation is placing one’s retirement plan bets on which managers will provide the highest returns in the future. Years ago, the betting was focused on individual stocks (company stock is a good example). But today it is largely speculation on future mutual fund performance where the past, alas, is rarely prologue to the future. Participants in DC plans are presently betting on an astonishing total of 562 different mutual funds, the vast majority of which are actively managed, often assuming extra market risk (see Box 7.3).

It is only in recent years that broadly diversified, passively managed index funds have come into their own. But despite their obvious suitability in DC plans, index funds represent but 25 percent of DC assets, albeit up from a 15 percent share 15 years ago. The increasingly popular “target date funds” (making portfolios gradually more conservative as the retirement date nears) are also beginning to make inroads. Despite their obvious sense, suitability, and low cost, target-date *index* funds have yet to dominate the field. (Most target date funds are actively managed.)

Excessive Costs. As noted earlier, excessive investment costs are the principal cause of the inadequate long-term returns earned by both stock mutual funds and bond mutual funds. The average equity fund carries an annual expense ratio of about 1.3 percent per year (somewhat lower when weighted by fund assets), consuming an incredible 65 percent of their current dividend yield of 2 percent, and leaving a puny yield of just 0.7 percent. But that is only part of the cost. Mutual funds also incur substantial transaction costs, reflecting the rapid turnover of their investment portfolios.

Last year, the average actively managed fund had a turnover rate of an astonishing 96 percent. Even if weighted by asset size, the turnover rate is still a shocking—if slightly *less* shocking—65 percent. Admittedly, the costs of this portfolio turnover cannot be measured with precision. But it is reasonable to assume that trading activity by funds adds costs of 0.5 percent to 1.0 percent to the dilution inflicted on returns by the expense ratio. So the all-in-costs of fund investing (*excluding* sales loads, which are generally waived for large retirement accounts) can run from, say, 1.5 percent to 2.3 percent per year. By contrast, low-cost market index funds—which I've discussed earlier—have expense ratios as low as 0.10 percent or less, with transaction costs that are close to zero.

In investing, costs truly matter, and they matter even more when related to real (after-inflation) returns. Let's assume again that future nominal investment return on a balanced retirement account were, say, 5.5 percent per year (3.5 percent nominal return for bonds, 7–8 percent for stocks). Adjusted for, say, 2.5 percent inflation, the real return would be just 3 percent. An annual cost of 2.0 percent would therefore consume fully 67 percent of that annual return, while a low-cost index fund with a cost of 0.1 percent would consume but 5 percent. Even worse, over an investment lifetime of, say, 50 years, these costs of active management would consume a staggering share of the potential wealth accumulation. It is an ugly picture.

Given the centrality of low costs to the accumulation of adequate purchasing power in retirement savings plans, it is high time that both the impact of inflation and the toll taken by costs are disclosed to participants. The disclosure must include the *all-in* costs of investing, not merely the expense ratios. However, I confess to being skeptical about a recent regulatory proposal that would apply cost-accounting processes to the

Box 7.3**Speculation: Betting on Mutual Funds by Retirement Plan Participants**

When 401(k) thrift plans began to develop some 30 years ago, the list of choices was usually limited to those funds under a given sponsor's management, but what gradually developed was a sort of "open architecture" plan, in which—while a single sponsor was responsible for the record keeping of participant accounts—a whole range of other funds could be selected. It is now typical for mutual fund managers to offer a wide selection of their funds to retirement plan participants. If "the more the choices, the better the outcome" were the rule, that expansion in options would be called progress. But the history of fund choice suggests that the reverse is true.

Let's look at the record, and examine the amounts held by 401(k) participants in individual mutual funds in 1997, then in 2012. The table below shows the 20 largest fund holdings, and the cumulative returns provided by each during the past 15 years and in 2012.

Domestic Equity Funds Most Used by DC Plans

1997				2012		
Fund	Assets (billions)	Return: 15 Years Ending March 2012		Fund	Assets (billions)	Return: 1 Year March 2012
		Annual	Cumulative			
1 Fidelity Magellan	\$30.3	4.5%	94.0%	1 American Funds Growth	\$67.6	3.5%
2 Vanguard 500 Index	14.8	6.0	140.3	2 Vanguard 500 Index	62.2	8.3
3 Fidelity Growth & Income	11.4	3.1	58.3	3 Fidelity Contrafund	44.7	9.4
4 Fidelity Contra	9.5	9.2	276.7	4 Fidelity Spartan 500 Index	23.7	8.4
5 Fidelity Equity Income	9.0	5.4	122.5	5 Fidelity Growth Co.	22.4	12.6

1997					2012		
Fund	Assets (billions)	Return: 15 Years Ending March 2012		Assets (billions)	Fund	Return: 1 Year March 2012	
		Annual	Cumulative				
6 Twentieth Century Ultra	8.2	5.6	127.0	6 Fidelity Low-Priced Stock	17.0	7.2	
7 Vanguard Windsor	7.7	5.9	137.9	7 Vanguard PRIMECAP	13.4	2.9	
8 Fidelity Growth Co.	5.6	9.2	276.8	8 Fidelity Magellan	10.6	-2.3	
9 Fidelity Spartan 500 Index	5.0	5.9	139.1	9 American Funds Fundamental	9.6	2.6	
10 Vanguard Windsor II	4.0	6.9	174.0	10 Vanguard Windsor II	9.5	8.3	
11 Investment Co. of America	4.0	7.1	180.2	11 American Funds Washington	9.5	8.4	
12 Fidelity Blue Chip Growth	3.9	5.9	137.4	12 Investment Co. of America	8.5	4.6	
13 Putnam Voyager	3.7	5.7	130.8	13 T. Rowe Price Midcap Growth	8.4	2.8	
14 Capital Research Washington	3.6	6.8	169.1	14 Columbia Acorn	7.6	4.2	
15 Merrill Lynch Basic Value	2.9	6.5	159.3	15 Neuberger Genesis	7.3	2.3	
16 Twentieth Century Growth	2.7	6.5	159.3	16 Fidelity Equity Income	6.5	-1.2	
17 Vanguard U.S. Growth Portfolio	2.5	2.2	38.6	17 T. Rowe Price Equity Income	5.6	4.5	
18 T. Rowe Price Equity Income	2.4	6.8	170.5	18 Fidelity Midcap Stock	5.2	3.3	
19 Neuberger & Berman Guardian	2.4	4.7	100.3	19 Fidelity Blue Chip Growth	5.1	9.2	
20 Janus	2.4	5.0	110.3	20 Goldman Sachs Midcap Value	5.1	-0.06	

SOURCE: Pensions & Investments.

(Continued)

Some Lessons

- There's a continuing change in leadership during the period. By 2011 six funds had disappeared from the 1997 list (often because of faltering performance), replaced by six new entrants (often with recent past returns that were superior).
- Magellan Fund, the top-performing fund of the 1970s and 1980s, stumbled badly (next to last performer during the past 15 years), and its long-time #1 rank in popularity fell to #10 in 2012. (Holdings by participants fell from \$30 billion to \$10 billion.)
- Index Funds rose sharply in popularity. Vanguard 500 rose from #8 to #2, with 401(k) holdings soaring from \$9 billion to \$62 billion. Similarly, Fidelity's Spartan U.S. Equity Index Fund jumped from #10 (\$5 billion) to #4 (\$24 billion.)
- Little magic can be found in the actively managed equity selections offered by 401(k) leaders Fidelity, Vanguard, and American Funds. During the 15-year period, these three firms had both winners and losers. For Fidelity, Magellan and Growth and Income stumbled badly, but Contrafund and Growth Fund enjoyed positive returns that were almost symmetrical, but in reverse. For Vanguard, Windsor II shone, but U.S. Growth failed badly. Both of the American Funds—Investment Company of America and Washington Mutual—had superlative records.
- The 15-year records illustrate the folly of believing that the past is prologue. It wasn't. In 2012, the returns for the top 20 funds were random. Magellan's earlier shortfall relative to the S&P 500 sharply accelerated. PRIMECAP did extremely well, and Vanguard's Windsor II continued to win. At Fidelity, Contrafund lagged slightly and Equity Income tumbled. At American, Growth, now the most popular fund in 401(K) plans (\$67 billion), performed poorly, as did Investment Company of America, but Washington Mutual experienced a one-year return that was first rate.

The inability of plan participants (and their advisers) to predict, in advance, patterns of performance seems obvious. If we look to, not merely the top 20 choices, but to *all* of the funds selected by participants, that message is magnified. Currently, participants have selected 562 individual funds, more what one would expect of stock-pickers rather than fund-pickers. The winning number, as it were, for 2012 was the 400th largest fund, Federated Strategic Value, with an 11.5 percent gain for the year; the losing number, Columbia Acorn, with a 16.5 percent loss—a spread of nearly 30 percentage points from best to worst. (The gap between the top and bottom deciles was of course smaller—+6 percent versus -10 percent, a 16-percentage-points spread. But that spread still made a huge difference.)

The 500 index funds of Vanguard and Fidelity were, inevitably, the surest bet; that is, the safest way to avoid both the extremes of underperformance and, necessarily, of overperformance. But by minimizing speculation on who will win and who will lose, that safe course guarantees—as it always has—that 401(k) participants who chose index funds will garner their fair share of whatever returns the stock market earns (or fails to earn).

allocation of fund expenses among investment costs, administrative costs, marketing costs, and record-keeping costs. What's important to plan participants is the amount of *total* costs incurred, not necessarily the allocation of those costs among the various functions as determined by accountants and fund managers who have vested interests in the outcome.

Failure to Deal with Longevity Risk. Even as most DC plan participants have failed to deal adequately with inflation risk, investment risk, and selection risk, so they (and employers and fund sponsors) have also failed to deal adequately with longevity risk. It must be obvious that at some point in an investment lifetime, most plan participants would be well served by having at least some portion of their retirement savings

provide income that they cannot outlive. But despite the fact that the 401(k) plan has now been around for three full decades, systematic approaches to annuitizing payments are rare and often too complex to implement. Further, nearly all annuities carry grossly excessive expenses, often because of high selling and marketing costs. Truly low-cost annuities remain conspicuous by their absence from DC retirement plan choices. (TIAA-CREF, operating at rock-bottom cost and providing ease and flexibility for clients using its annuity program, has done a good job in resolving both the complexity issue and the cost issue.)

Lack of Investor Education. While defined contribution plans give investors the ability to customize their retirement accounts to their specific circumstances, far too often investors have not been given the tools that they need to make financial decisions that are in their own best interests. The shift towards defined contribution retirement plans has essentially thrust the head of each participating household into the role of pension plan manager, a role for which they are not properly prepared and are often reluctant to assume. As a result, retirement savers make many of the mistakes already discussed—not saving enough, being either too conservative or too aggressive in their asset allocation, taking loans from a 401(k), cashing out early—simply because they’ve received inadequate preparation for these critical investment decisions. The fund industry has not helped, marketing their hottest funds and giving inadequate attention to the critical role played by asset allocation.

The New Pension Plan

Given the tenuous funding of DB plans, the widespread failures in the existing DC plan structure—including both 401(k) plans and IRAs—we ought to carefully consider and then implement changes that move us to a retirement plan system that is simpler, more rational, and less expensive. The new system must be one that will be increasingly and inevitably focused on DC plans, albeit those that can to some degree emulate the security of DB plans. (Our Social Security System and, at least for a while, our state and local government systems would continue to provide the DB backup as a “safety net” for all participating U.S. citizens.) It is time

for reform—a reform that serves, not fund managers and our greedy financial system, but plan participants and their beneficiaries.

I am hardly alone in my critique of today's retirement system, nor in my struggle to build a better one. Consider the words that follow from the respected pension strategist Keith Ambachtsheer, Director of the Rotman International Centre for Pension Management at the University of Toronto. In his remarks, prepared for a *FairPensions* event at Westminster Hall, Houses of Parliament, London, on November 15, 2011, he provides excellent ideas about how to assure wealth across the generations. Some excerpts are presented in Box 7.4.

Box 7.4

Wealth across Generations: Can Pension Funds Shape the Future of Capitalism?

By Keith Ambachtsheer

It is within our reach to move capitalism in a direction that is more wealth-creating, more sustainable, less crisis-prone, and more legitimate than the “headwinds” capitalism we have today. Why specifically pension funds (including both defined contribution and defined benefit plans)? Because they are the only global investor class which has a fiduciary duty to invest across generations. In determining their investment strategies, pension funds are duty-bound to be even-handed between the financial needs of today's pensioners and those of young workers whose retirement years lie 30, 40, 50 years ahead of them.

However, this transformation to “pension fund capitalism” will not be easy for two reasons: (1) It requires the redesign of pension systems so these systems themselves become more sustainable and intergenerationally fair. (2) It requires the redesign of pension fund organizations so that they *themselves* become more effective and hence more productive

(Continued)

stewards of the retirement savings of young workers and pensioners alike.

The designs of traditional DC and DB plans are both problematical:

1. Traditional DC plans force contribution rate and investment decisions on participants that they cannot, and do not want to make. Also, little thought has been given to the design of the post-work asset decumulation phase. As a result, DC plan investing has been unfocused, and post-work financial outcomes have been, and continue to be highly uncertain, raising fundamental questions about the effectiveness and sustainability of this individualistic pension model.
2. Traditional DB plans lump the young and the old on the same balance sheet, and unrealistically assume they have the same risk tolerance and that property rights between the two groups are clear. These unrealistic assumptions have had serious consequences. Over the course of the last decade, aggressive return assumptions and risk-taking—together with falling asset prices, falling interest rates, and deteriorating demographics—have punched gaping holes in many DB plan balance sheets, to which unfocused responses have ranged the full spectrum—from complete de-risking at one end to piling on more risk at the other . . .

Pension systems have two goals: (1) a pension affordability for workers (and their employers), and (2) certainty for pensioners. Therefore they must offer participants two instruments: a long-horizon (LH) return maximization instrument to support the affordability goal, and an asset-liability matching instrument to support the payment certainty goal. Logically, younger workers should favor return maximization, and pensioners should favor payment certainty. Over the course of their working lives, participants should transition steadily from the former goal to the latter.

Unfortunately, there continues to be considerable resistance to adopting this more transparent, robust “two goals/two instruments” pension model. Some continue to defend traditional DB models for emotional rather than rational reasons; others continue to defend the “caveat emptor” philosophy of traditional DC plans because they profit from it. But the “two goals two instruments” design feature is critically important to pension funds ability to reshape capitalism. Without the existence and legitimacy of highly focused, well-managed long-horizon return-maximization instruments, pension funds *cannot* play the wise intergenerational investor role that we have cast them in. . . .

I put to you that if we could achieve that vision, we would not just create more wealth for current and future pensioners. We would in the process transform today's “headwinds” capitalism into a more sustainable, wealth-creating version that is less prone to generate the financial bubbles and crises of the last decade, and more legitimate in the skeptical eyes of today's occupiers of Wall Street.

What's to Be Done?

Where there are multiple sins and flaws, as there are in today's retirement system, there are multiple opportunities for improvement. So as we work toward the ideal of “The New Pension Plan” just described—with pension funds helping to shape the future of capitalism—here are five specific recommendations toward that end.

Simplify the DC System

Offer a single DC plan for tax-deferred retirement savings available to all of our citizens (with a maximum annual contribution limit), consolidating today's complex amalgam of traditional DC plans, IRAs, Roth IRAs, 401(k) plans, 403(b) plans, and the federal Thrift Savings Plan. I envision the creation of an independent Federal Retirement Board to oversee both the employer sponsors and the plan providers, assuring that the interests of plan participants are given the highest priority. This new

system would remain in the private sector (as today), with asset managers and record keepers competing in costs and in services. (Such a board might also create a public sector DC plan for wage earners who are unable to enter the private system or whose initial assets are too modest to be acceptable in that system.)

Get Real about Stock Market Return and Risk

Financial markets, it hardly need be said today, can be volatile and unpredictable. But common stocks remain a perfectly viable—and necessary—investment option for long-term retirement savings. Yet stock returns have been oversold by Wall Street’s salesmen and by the mutual fund industry’s giant marketing apparatus. In their own financial interests, they ignored the fact that the great bull market we enjoyed during the final 25 years of the twentieth century was in large part an illusion, creating what I call “phantom returns” that would not recur. Think about it: From 1926 to 1974, the average annual real (inflation-adjusted) return on stocks was 6.1 percent. But during the following quarter-century, stock returns soared, an explosion borne, not of the return provided by corporations in the form of dividend yields and earnings growth, but of soaring price-to-earnings ratios, what I define as *speculative* return. By 1999, that long-term rate of real returns had jumped to 12 percent.

This higher market valuation reflected investor confidence—along with greed—produced an extra speculative return of 7 percent annually—resulting in a cumulative increase of 400 percent in final value for the full 25 years, a staggering accretion without precedent in financial history. This speculative return almost doubled the market’s *investment* return (created by dividend yields and earnings growth), bringing the market’s total real return to nearly 12 percent per year. From these speculative heights, the market had little recourse but to return to normalcy, by providing far lower returns in subsequent years. And in fact, the real return on stocks since the turn of the century in 1999 has been minus 7 percent per year, composed of a negative *investment* return of –1 percent and, as price-earnings multiples retreated to (or below) historical norms, a negative *speculative* return of another –6 percent.

The message here is that investors in their ignorance, and financial sector marketers with their heavy incentives to sell, well, “products,” failed to make the necessary distinction between the returns earned by business (earnings and dividends) and the returns earned by irrational exuberance and greed. In retrospect, we now realize that much of the value we saw reflected on our quarterly 401(k) statements in 1999 (and again in 2007) was indeed *phantom wealth*. But as yesteryear's stewards of our investment management firms became modern-day salesmen of investment products, they had every incentive to disregard the fact that this wealth could not be sustained. Our marketers (and our investors) failed to recognize that only fundamental (investment) returns apply as time goes by. As a result, we misled ourselves about the realities that lay ahead, to say nothing of the risks associated with equity investing.

Reduce Participant Flexibility

Both the “open architecture” plan that I described earlier and the near-freedom to withdraw assets from DC plans have ill-served investors. Limiting choices is relatively easy to understand and to achieve. But it will take major reform to reduce the flexibility that plan participants presently enjoy to draw down their cash almost at will (albeit sometimes with tax penalties). If the DC plan is to reach its potential as a retirement savings vehicle, there must be substantial limits—including larger penalties—on cash-outs and loans, no matter how painful in the short term. (Just imagine what would have happened to our Social Security if participants had withdrawal rights!) Importantly, 401(k) plans were originally designed as *thrift savings plans*. They need to have far more emphasis on their role as *thrift retirement plans* than we expect them to play today.

A poignant example of the flaws in our 401(k) savings plans, shared by our IRA plans, came from financial writer (*A Piece of the Action: How the Middle Class Joined the Money Class*, Simon & Schuster, 1994) and *The New York Times* editorial board member Joe Nocera. In his April 28, 2012 column, entitled, “My Faith-Based Retirement,” he identified many of the procedural and human barriers that stand between opening a retirement account, and building it into a meaningful asset to fund one's retirement. Box 7.5 presents some excerpts.

Box 7.5**My Faith-Based Retirement***By Joe Nocera*

“My 60th birthday is less than a week and a half away. . . . The only thing I haven’t dealt with on my to-do checklist is retirement planning . . . [But] I can’t retire. My 401(k) plan, which was supposed to take care of my retirement, is in tatters. Like millions of other aging baby boomers, I first began putting money into a tax-deferred retirement account a few years after they were legislated into existence in the late 1970s. The great bull market, which began in 1982, was just gearing up.

“As a young journalist, I couldn’t afford to invest a lot of money, but my account grew as the market rose, and the bull market gave me an inflated sense of my investing skills. I became an enthusiast of the new investing culture, and I argued that the little guy have the same access to the markets as the wealthy. In the boom, I didn’t make much of the decline of pensions. After all, we were in the middle of the tech bubble by then.

“The bull market ended with the bursting of that bubble in 2000. My tech-laden portfolio was cut in half. A half-dozen years later, I got divorced, cutting my 401(k) in half again. A few years after that, I bought a house that needed some costly renovations. Since my retirement account was now hopelessly inadequate for actual retirement, I reasoned that I might as well get some use out of the money while I could. So I threw another chunk of my 401(k) at the renovation. That’s where I stand today. . . .

“The 401(k) is a failed experiment. . . . It is time to rethink it. . . . Most human beings lack the skill and emotional wherewithal to be good investors. Linking investing and retirement has turned out to be a recipe for disaster.”

Own the Stock Market

Investors seem to largely ignore the close link between lower costs and higher returns—what I have called earlier “The Relentless Rules of Humble Arithmetic.” Plan participants and employers also ignore this essential truism: In the aggregate, we investors are all “indexers.” That is, all of the equity owners of U.S. stocks together own the entire U.S. stock market. So our collective gross return inevitably equals the return of the stock market itself.

And because providers of financial services are largely smart, ambitious, aggressive, innovative, entrepreneurial, and, at least to some extent, greedy, it is in their own financial interest to have plan sponsors and participants ignore that reality. Our financial system pits one investor against another, buyer versus seller. Each time a share of stock changes hands (and today's daily volume totals some 10 billion shares), one investor is (relatively) enriched; the investor on the other side of the trade is (relatively) impoverished. That diverse collection of 562 equity funds now held in 401(k) plans, combined in the aggregate, in fact owns the stock market itself. In substance, the winning funds' excess returns are offset by the losing funds' shortfalls. The obvious conclusion: *We're all indexers now.*

But, as noted earlier, this is no *zero-sum game*. The financial system—the traders, the brokers, the investment bankers, the money managers, the middlemen, “Wall Street,” as it were—takes a cut of all this frenzied activity, leaving investors as a group inevitably playing a *loser's game*. As bets are exchanged back and forth, our attempts to beat the market, and the attempts of our institutional money managers to do so, then, enrich only the croupiers, a clear analogy to our racetracks, our casinos, and our state lotteries.

So, if we want to encourage and maximize the retirement savings of our citizens, we must drive the money changers—or at least most of them—out of the temples of finance. *If we investors collectively own the markets, but individually compete to beat our fellow market participants, we lose. But if we abandon our inevitably futile attempts to obtain an edge over other market participants and all simply hold our share of the market portfolio, we win.* (Please re-read those two sentences!) Truth told, it is as simple as that. So our Federal Retirement Board should not only foster the use of broad-market index funds in the new DC system (and offer them in its own “fallback”

system described earlier) but approve only private providers who offer their index funds at minimum costs.

Balance Risk and Return through Asset Allocation

The balancing of return and risk is the quintessential task of intelligent investing, and that task too would be the province of the Federal Retirement Board. If the wisest, most experienced minds in our investment community and our academic community believe—as they do—that the need for risk aversion increases with age; that market timing is a fool’s game (and is obviously not possible for investors as a group); and that predicting stock market returns has a very high margin for error, then something akin to roughly matching the bond index fund percentage with each participant’s age with the remainder committed to the stock index fund, is the strategy that is most likely to serve most plan participants with the most effectiveness. Under extenuating—and very limited—circumstances, participants could have the ability to opt out of that allocation.

This allocation pattern is clearly accepted by most fund industry marketers, in the choice of the bond/stock allocations of their increasingly popular “target retirement funds.” However, too many of these fund sponsors apparently have found it a competitive necessity to hold stock positions that are significantly higher than the pure age-based equivalents described earlier. I don’t believe competitive pressure should be allowed to establish the allocation standard, and would leave those decisions to broad policies set by the new Federal Retirement Board.

I also don’t believe that past returns on stocks that include, from time to time, substantial phantom returns—born of swings from fear to greed to hope, back and forth—are a sound basis for establishing appropriate asset allocations for plan participants. Our market strategists, in my view, too often deceive themselves by their slavish reliance on past returns, rather than focusing on what returns may lie ahead, based on the projected discounted future cash flows that, however far from certainty, represent the intrinsic values of U.S. business in the aggregate.

Once we spread the risk of investing to investors as a group, we’ve accomplished the inevitably worthwhile goal: a low-cost financial

system that is based on the wisdom of long-term investing, eschewing the fallacy of the short-term speculation that is so deeply entrenched in our markets today. To do so, we must first eliminate the risk of picking individual stocks, of picking market sectors, and of picking money managers, leaving only market risk, which cannot be avoided. Such a strategy effectively *guarantees* that all DC-plan participants will garner their fair share of whatever returns our stock and bond markets are generous enough to bestow on us (or, for that matter, mean-spirited enough to inflict on us). Compared to today's loser's game, that would be a signal accomplishment.

Under the present system, some of us will outlive our retirement savings and depend on our families. Others will go to their rewards with large savings barely yet tapped, benefiting their heirs. But like investment risk, longevity risk can be pooled. So as the years left to accumulate assets dwindle down, and as the years of living on the returns from those assets begin, we need to institutionalize, as it were, a planned program of conversion of a portion of our retirement plan assets into annuities. (It could well be integrated with a plan most of us already have, one that includes defined benefits, an inflation hedge, and virtually bulletproof credit standing. It is called "Social Security.")

This evolution will be a gradual process; it could be limited to plan participants with assets above a certain level; and it could be accomplished by the availability of annuities created by private enterprise and offered at minimum cost, again with providers overseen by the proposed Federal Retirement Board (just as the federal Thrift Savings Plan has its own board and management, and operates as a private enterprise).

Focus on Mutuality, Investment Risk, and Longevity Risk

The pooling of the savings of retirement plan investors in this new pension fund environment is the *only* way to maximize the returns of these investors as a group. The pool would feature a widely diversified, all-market strategy, a rational (if inevitably imperfect) asset allocation, and low costs, and be delivered by a private system in which investors automatically and regularly save from their own incomes, aided where possible by matching contributions of their employers, and would prove that an annuity-like mechanism to minimize longevity risks is the

optimal system to assure maximum retirement plan security for our nation's families.

There remains the task of bypassing Wall Street's croupiers, an essential part of the necessary reform. Surely our Federal Retirement Board would want to evaluate the need for the providers of DC retirement plan service to be highly cost-efficient, or even to be *mutual* in structure; that is, management companies that are owned by their fund shareholders and operated on an "at-cost" basis; and annuity providers that are similarly structured. The arithmetic is there, and the sole mutual fund firm that is organized under such a mutual structure has performed with remarkable effectiveness.⁵

Of course that's my view! But this critical analysis of the structure of the mutual fund industry is not mine alone. Hear this from another investor, one who has not only produced one of the most impressive investment records of the modern era but who has an impeccable reputation for character and intellectual integrity, David F. Swensen, Chief Investment Officer of Yale University:

The fundamental market failure in the mutual fund industry involves the interaction between sophisticated, profit-seeking providers of financial services and naïve, return-seeking consumers of investment products. The drive for profits by Wall Street and the mutual fund industry overwhelms the concept of fiduciary responsibility, leading to an all too predictable outcome: . . . the powerful financial services industry exploits vulnerable individual investors. . . . The ownership structure of a fund management company plays a role in determining the likelihood of investor success. . . .

Mutual fund investors face the greatest challenge with investment management companies that provide returns to public shareholders or that funnel profits to a corporate parent—situations that place the conflict between profit generation and

⁵I'm only slightly embarrassed again to be referring to Vanguard, the firm I founded 35 years ago. But it's difficult to argue with Vanguard's leadership in providing superior investment returns, in operating by far at the lowest costs in the field, in earning shareholder confidence, and in developing positive cash flows into our mutual funds (even in the face of huge *outflows* from funds operated by our rivals).

fiduciary responsibility in high relief. When a fund's management subsidiary reports to a multi-line financial services company, the scope for abuse of investor capital broadens dramatically. . . .

Investors fare best with funds managed by not-for-profit organizations, because the management firm focuses exclusively on serving investor interests. No profit motive conflicts with the manager's fiduciary responsibility. No profit margin interferes with investor returns. No outside corporate interest clashes with portfolio management choices. Not-for-profit firms place investor interests front and center. . . . Ultimately, a passive index fund managed by a not-for-profit investment management organization represents the combination most likely to satisfy investor aspirations.

What Would an Ideal Retirement Plan System Look Like?

However difficult to implement, it is easy to summarize the five elements of an ideal system for retirement savings that I've presented.

1. Social Security would essentially remain in its present form, offering basic retirement security for our citizens at minimum investment risk. (However, policymakers must promptly deal with its longer-run deficits.)
2. For those who have the financial ability to save for retirement, there would be a single DC structure, dominated by low-cost—even mutual—providers, inevitably focused on all-market index funds investing for the long term, and overseen by a newly created Federal Retirement Board that would establish sound principles of asset allocation and diversification in order to ensure appropriate investment risk for plan participants, as well as stringent limits on participant flexibility.
3. Retirement savings would continue to be tax-deferred, but with a dollar limitation on aggregate annual contributions by any individual, and a similar limit on the amount that is tax-deductible.
4. Longevity risk would be mitigated by creating simple low-cost annuities as a mandatory offering in these plans, with some portion

of each participant's balance going into this option upon retirement. (Participants should have the ability to opt out of this alternative.)

5. We should extend the existing ERISA requirement that plan *sponsors* meet a standard of fiduciary duty to encompass plan *providers* as well as the corporations themselves. (As noted earlier, I also believe that a federal standard of fiduciary duty for all money managers should be enacted.)

The system I'd like to see may not be—indeed, it is not—a system free of flaws. But it is a radical improvement, born of common sense and elemental arithmetic, over the present system, which is driven by the interests of Wall Street rather than Main Street. With the creation of an independent Federal Retirement Board, we have the flexibility to correct flaws that may develop over time, and assure that the interests of workers and their retirement security remain paramount. But the central principle remains: *minimize the impact of all of the various forms of speculation that plague our complex present-day national retirement plan system, vastly simplify it, slash the costs of it, assure its fairness to society, and maximize its focus on long-term investment.*

* * *

The perils of speculation and the merits of investment are not merely concepts. They are real factors in determining how the process of asset allocation and portfolio management actually functions. My career has fortified my strong views of this distinction, made real and tangible by my first-hand experience in the management of Wellington Fund during 61 years of its 83-year history. The next chapter tells this tale of triumph and tragedy and triumph.



PERSPECTIVES

The Arithmetic of “All-In” Investment Expenses

John C. Bogle

This article represents a rare (if not unique) attempt to estimate the drag on mutual fund returns engendered by “all-in” investment expenses, including not only expense ratios (until now, the conventional measure of fund costs) but also fund transaction costs, sales loads, and cash drag. Compared with costly actively managed funds, over time, low-cost index funds create extra wealth of 65% for retirement plan investors.

I read William Sharpe’s essay “The Arithmetic of Investment Expenses” (2013) with interest and applause (of course!). It brought to my mind what was likely his first article on the subject of fund costs—“Mutual Fund Performance”—published way back in 1966. In that article, Dr. Sharpe was right in his conclusion that “all other things being equal, the smaller a fund’s expense ratio, the better the results obtained by its stockholders” (p. 137).

Sharpe’s credibility, objectivity, and quantification expertise are peerless. He was the 1990 recipient of the Nobel Prize in Economic Sciences and is now professor emeritus of finance at Stanford University, where he has taught thousands of students over some 43 years. He was right again in his 2013 article: “A person saving for retirement who chooses low-cost investments could have a standard of living throughout retirement more than 20% higher than that of a comparable investor in high-cost investments” (p. 34). However, as I will explain, he understated the gap in favor of low-cost investments.

The 1991 Article

Sharpe has taken up this subject often. In “The Arithmetic of Active Management” (Sharpe 1991), he analyzed mutual fund returns and found the same forces at work:

Statements such as [“the case for passive management rests only on complex and unrealistic theories of equilibrium in capital markets”] are made with alarming frequency by investment professionals.

John C. Bogle is founder and former chief executive of the Vanguard Group and president of the Bogle Financial Markets Research Center.

In some cases, subtle and sophisticated reasoning may be involved. More often (alas), the conclusions can only be justified by assuming that the laws of arithmetic have been suspended for the convenience of those who choose to pursue careers as active managers.

If “active” and “passive” management styles are defined in sensible ways, it *must* be the case that (1) before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and (2) after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar. These assertions will hold for *any* time period. Moreover, they depend *only* on the laws of addition, subtraction, multiplication and division. Nothing else is required. . . .

Because active and passive returns are equal before cost, and because active managers bear greater costs, it follows that the after-cost return from active management *must* be lower than that from passive management.

. . . The proof is embarrassingly simple and uses only the most rudimentary notions of simple arithmetic.

Enough (lower) mathematics. . . .

. . . Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement. (pp. 7–8)

The 1966 Article

Surprising as it may seem, Sharpe's 1991 article was published a quarter century after his first article on this subject. Although the role of costs in shaping the relative performance of mutual funds was integral to my career even before I founded Vanguard in 1974, it took me a while to pay adequate attention to that seminal article. The following are excerpts from Sharpe's 1966 article:

Past performance [based on the ratio of annual fund returns to volatility in net asset values] appears to provide a basis for predicting future performance. . . . The high correlation among mutual fund rates of return suggests that most accomplish the task of diversification rather well. Differences in performance are thus likely to be due to either differences in the ability of management to find incorrectly priced securities or to differences in expense ratios. If the market is very efficient, the funds spending the least should show the best (net) performance. . . . The results tend to support the cynics: good performance is associated with low expense ratios. . . .

. . . All other things being equal, the smaller a fund's expense ratio, the better the results obtained by its stockholders. . . . But the burden of proof may reasonably be placed on those who argue the traditional view—that the search for securities whose prices diverge from their intrinsic values is worth the expense required. (pp. 131–132, 137–138)¹

The Arithmetic of “All-In” Investment Expenses

I enthusiastically endorse Sharpe's conclusions and his perceptive analysis, but the use of a mutual fund's expense ratio offers only a pale approximation of the total costs paid by investors in actively managed equity funds. Using only that measure, Sharpe compared the reported expense ratio of 1.12% for the average large-cap blend fund (unweighted by assets) with the ratio of 0.06% for the Vanguard Total Stock Market Index Fund. The advantage of the low-cost investment over the higher-cost investments was 1.06 percentage points per year. In this article, I shall provide careful, if inevitably imprecise, estimates of the additional costs that investors in actively managed equity funds incur—few, if any, of which are incurred by index fund investors.

Focusing on the issue of fees charged by brokers in his 1966 article, Sharpe perceptively referred to the fact that the costs included in mutual fund expense ratios fail to capture the all-in costs borne by fund investors:

One reservation is in order. Expense ratios as reported do not include all expenses; brokers' fees are omitted. Thus the expense ratio does not capture all the differences in expenses among funds. It is entirely possible that funds with performance superior to that predicted by the traditional expense ratio engage in little trading, thereby minimizing brokerage expense. It was not feasible to attempt to measure total expense ratios for this study; had such ratios been used, a larger portion of the difference in performance might have been explained in this manner, and the apparent differences in management skill might have been smaller. (p. 134)

Despite the sharp decline in the commission rates charged by brokers, the costs of the portfolio transactions incurred by actively managed funds are substantial; fund portfolio turnover (based on aggregate industry data) has leaped almost fivefold since the early 1960s—from 30% to 140% today.²

In addition, Sharpe neglected to note that front-end sales loads were a major cost. But their impact on annual returns depends on the (unknowable) holding period of the investor. Furthermore, front-end loads are far less common today; they have typically been replaced by deferred sales loads and annual fees charged by brokers and advisers. Also, there are far more pure no-load funds in the fund industry of today.

Moreover, whereas index funds are fully invested at all times, portfolios of actively managed funds typically carry a cash position of about 5%, causing the funds to lose a portion of the long-term equity premium.

Finally, for most investors, relative tax efficiency is a critically important element of total costs. Funds with low expense ratios (notably, index funds), which operate with minimal portfolio turnover, are relatively tax efficient. Actively managed funds, with their far higher expense ratios, not only incur substantial transaction costs on their portfolio turnover but also realize capital gains, generating significant tax inefficiency. Taxes represent an additional drag on the returns earned by mutual fund investors in taxable accounts, but they are of no immediate concern to investors in tax-deferred retirement plans.

In this article, I shall estimate the impact of (1) the first three of these extra cost categories—transaction costs, cash drag, and sales loads—on the net returns that funds deliver to their retirement plan investors and, separately, (2) all four costs, including excess taxes, on the returns delivered to taxable fund investors.

Quantitative Imprecision

The issue of all-in fund costs has rarely, if ever, been subject to careful examination, likely because data on these costs are difficult, if not impossible, to quantify with precision. So, where is a businessman like me (albeit one educated in economics) to turn? The kind of quantitative precision that the academic community properly demands in most cases is simply not possible with respect to these four costs that fund investors incur over and above the expense ratio. I will provide reasonable estimates for each based on a variety of sources and data, buttressed by my industry experience. Lest I overstate the advantages of indexing, I have made these cost estimates for actively managed funds as conservative as possible.

Transaction Costs

The first "invisible" fund costs are the transaction costs incurred by the funds themselves. Two academic studies have produced rather different estimates of the drain of fund trading costs in order to calculate their annual impact on fund returns. One study was conducted by Dr. John A. Haslem (2006). Brokerage commissions are now required to be specified by equity mutual funds, and from this source, Haslem identified a performance drag on fund annual returns of 39 basis points (bps). After taking into account implicit trading costs (timing delays, market impact, etc.), he estimated that the trading costs of actively managed funds produced an annual impact on fund returns of -60 bps.

Edelen, Evans, and Kadlec (2013) provided another extensive study of this issue. They examined the annual expenditures on trading costs incurred by 1,758 domestic equity funds over 1995–2006 and calculated average annual trading costs of 1.44%, far in excess of the average expense ratio of 1.19% for the funds they examined.

That surprisingly large number astonished at least one independent expert. Don Phillips, president of the investment research division at the mutual fund data provider Morningstar, described it as "preposterous." But he conceded that "trading is a real cost and an activity that is often counterproductive in asset management." He presented his own estimate of annual transaction costs of "about

30 bps, which does not include certain other costs," such as the substantial market impact, which he did not quantify (Phillips 2013, p. 80).

I have been examining this issue for many years and have shown that high turnover is negatively correlated with fund performance (Bogle 2012, p. 148). In this article, I use the actual measure of fund trading: portfolio purchase of stocks *plus* portfolio sales as a percentage of fund average assets. For reasons lost in history, however, funds now calculate turnover as the *lesser* of portfolio purchases or sales as a percentage of fund average assets—a figure that obviously understates transaction activity and is, therefore, irrelevant in the calculation of total transaction costs.

I am also aware that because mutual fund managers are trading largely with one another and with other institutional fund managers, market impact must resemble a zero-sum game for fund managers as a group (and their fund shareholders). Because a fund "taking a haircut" on selling a large block of stock results in a better price for the buying counterparty, I am inclined to consider market impact costs to be close to zero. But for investors as a group, after accounting for bid-ask spreads and commissions that brokers pay to brokers and dealers, trading obviously becomes a loser's game.

So for my analysis, I use an estimate that is far more conservative than the 1.44% calculated by Edelen et al. (2013) and even lower than the Haslem (2006) estimates. My estimate is likely consistent with the expanded estimate provided by Phillips. Because precision here is impossible—and I do not want to risk overstating these costs—I opt for the ease of "rounding" and assume just 50 bps for the transaction costs of actively managed funds.

Although index funds obviously incur some transaction costs, they are so minimal that they have had no significant impact on the returns of those funds. That is, the annual returns of major large-cap index funds lag those of their target indices by only the amount of their expense ratios, meaning that net transaction costs are too small to affect the precision with which they track their target indices. So, I assume zero total transaction costs for the index fund.

Cash Drag

Another additional cost is the drag of cash. Active funds fairly consistently carry cash in the range of 5% of assets, whereas index funds are normally fully invested. If we assume an annual long-term equity premium for stocks over cash of as little as 6%, there would be an additional 30 bp drag on active fund returns. Some of the larger active

equity funds doubtless “equitize” part of this cash by holding index futures. But data on that usage are simply not available. So, I will add a cost of just 15 bps to account for the cash holdings of active funds.

Sales Loads: Direct and Indirect

The costs paid directly by investors for fund distribution are rarely, if ever, taken into account in the analysis of fund expenses and returns. Nonetheless, these expenses incurred by most mutual fund “retail” investors represent a major drag on fund returns. That cost was once relatively easy to estimate because this industry originally grew through a “sales push” distribution system. From the inception of the fund industry in 1924 through the late 1970s, it was dominated by fund distributors that charged sales loads averaging about 8% of the dollar amount of shares purchased. (Then, few firms operated on a “no-load” basis.)

So in those days of yore, the math was fairly straightforward: For the typical investor who paid an 8% front-end load and held his shares for eight years, the amortized load was 100 bps per year; for a 16-year holder, 50 bps per year. (The norm was likely closer to 100 bps.) Today, however, the distribution system has undergone a radical transformation, and we can only make reasonable estimates based on limited data.

First, no-load funds have soared in importance: They now account for almost half of long-term industry assets (excluding assets of institutional funds).³ Further, the typical front-end sales load has dropped from 8% to 5%. Also, the “retail” distribution system is rapidly changing from a front-end load model to an annual asset charge. And even load funds often waive sales charges for pension plans and corporate thrift plans, as well as for registered investment advisers and brokers, who charge their clients an annual fee, replacing the earlier front-end commission-based model. Recent estimates suggest that only 40% of the traditional

“A” front-end load shares carry sales loads and 60% are sold at net asset value.

To further muddle the calculation of “distribution drag,” some individual investors are DIY (“do it yourself”) investors, incurring few, if any, extra costs. But most rely on brokers and advisers who charge fees for their services. A recent survey, based on a limited sample, placed the proportion of equity fund owners in this adviser-assisted category at 56% of total no-load fund sales.⁴

In this new environment, fees paid by investors to brokers and investment advisers typically run to about 1% per year, (indirectly) reflecting the costs of fund share distribution. Therefore, with some investors incurring almost no additional distribution costs and others subject to costs in the range of 1% or more, I will conservatively use an average annual distribution cost of 0.5% for individual investors in actively managed funds, which includes total annual broker and adviser costs and sales loads. Because no major index fund charges sales loads and because investors in traditional index funds are largely, but not entirely, DIY investors (often in defined contribution plans for which the sponsoring company provides the fund menu), I take the liberty of assuming in my basic analysis no such distribution costs for index funds.⁵ (Readers who believe that I have overstated or understated the distribution costs for either actively managed funds or index funds may simply insert their own cost assumptions into Table 1.)

Note that investors in corporate defined contribution (DC) plans are a major force in retirement plan investing and may well be subject to lower distribution costs.⁶ But individual retirement accounts (IRAs) have an even larger asset base (\$5.4 trillion versus \$5.1 trillion for DC plans at the end of 2012).⁷ A significant portion of IRA assets are the result of DC plan rollovers at retirement, and such investors seem more likely to retain brokers and advisers for their IRAs, incurring the distribution costs noted above.

Table 1. All-In Investment Expenses for Retirement Plan Investors

	Actively Managed Funds	Index Funds	Index Advantage
Expense ratio ^a	1.12%	0.06%	1.06%
Transaction costs	0.50	0.00	0.50
Cash drag	0.15	0.00	0.15
Sales charges/fees ^b	0.50	0.00	0.50
All-in investment expenses	2.27%	0.06%	2.21%

^aData are from Sharpe (2013).

^bThe 0.50% estimate for sales charges/fees is the midpoint of the range between 0% for DIY investors and 1% for investors who pay sales loads and fees to brokers and registered investment advisers. I have chosen not to include the “service charges” for loans, withdrawals, and so forth, often paid by investors in 401(k) retirement plans.

Putting It All Together

Table 1 details the all-in aggregate fund costs, beginning with Sharpe's data and then including the additional elements described previously. I will start by looking at these all-in costs from the perspective of Sharpe's 2013 article: the tax-deferred retirement plan of the individual investor.

Note that the pervasive acceptance of presenting expenses as a percentage of fund asset values, as in Table 1, greatly diminishes the perception of the substantial impact that costs have on fund annual returns. For example, assuming a 7% stock market return, the 2.27% estimated annual cost of the actively managed funds would consume almost 33% of the return, whereas the 0.06% annual cost of the index fund would consume less than 1% of the return—a dramatic difference.

Preparing for Retirement

What does this annual differential mean to an investor who prepares for retirement by owning mutual funds over the long term? For illustrative purposes, I have assumed that a 30-year-old investor begins to save for retirement at age 70, a span of 40 years, by investing in a tax-deferred 401(k) or IRA plan. She earns \$30,000 annually at the outset, and I assume that her compensation will grow at a 3% annual rate thereafter. In Table 2, I present a comparison of the retirement plan accumulation if the investor were to invest 10% of her compensation each year in either (1) an actively managed large-cap equity fund or (2) the Vanguard Total Stock Market Index Fund, the subjects of Sharpe's 2013 analysis. The table summarizes the results over the four decades that follow.

The advantage provided by the index fund is substantial, and as time passes, it grows by leaps and bounds. By the time retirement comes, when the investor in the example is 70 years old, \$927,000

would have been accumulated in the index fund versus \$561,000 in the active fund, an astonishing gap of \$366,000 and a 65% enhancement in capital. Even if we assume that the actively managed fund investor incurs no distribution costs, the 40-year accumulation would total \$626,000. If the index fund investor incurs distribution costs of 0.5% per year, the accumulation would total \$824,000 and the index fund investor would nonetheless maintain a \$198,000 advantage over the investment lifetime—still a 32% enhancement.

When Sharpe considered only the difference in expense ratios for index and actively managed funds, he concluded that "a person saving for retirement who chooses low-cost investments could have a standard of living throughout retirement more than 20% higher than that of a comparable investor in high-cost investments" (2013, p. 34). But when all-in costs—which obviously (1) exist and (2) are substantial, whatever their precise amount—are considered, the assumed retirement wealth accumulation enhancement provided by the low-cost index fund as shown in Table 2 leaps to fully 65% higher, ranging (depending on the assumptions presented in the table) from 32% to 86% higher. Regardless of the assumptions used, the index fund would provide a truly remarkable potential improvement in the standard of living for retirees. For example, using my primary calculations and assuming a 4% annual withdrawal rate at retirement, the average active fund investor would receive a monthly check for \$1,870 whereas the index fund investor would receive \$3,090.

Taxes and Taxable Investors

For taxable fund investors, the gap widens even further. The high tax *efficiency* of the index fund gains a significant advantage over the painful tax *inefficiency* of the average actively managed fund.

Table 2. Total Wealth Accumulation by Retirement Plan Investors, Assuming a 7% Nominal Annual Return on Equities

	Actively Managed Fund	Index Fund	Index Enhancement	
Gross annual return	7.00%	7.00%	—	
All-in costs	2.27	0.06	-2.21%	
Net annual return	4.73	6.94	+2.21	
Accumulation period				% Increase
After 10 Years	\$44,000	\$50,000	\$6,000	13%
After 20 Years	130,000	164,500	34,500	27
After 30 Years	286,000	412,000	126,000	44
After 40 Years ^a	561,000	927,000	366,000	65

^aFor the DIY investor in the active fund who incurs 0% distribution costs, the accumulation would amount to \$626,000. For an active fund investor who incurs the full 1% distribution cost, the accumulation would total \$504,000. For the index fund investor who incurs distribution costs of 0.5%, the accumulation would total \$824,000.

Again, it is impossible to make precise calculations here. Therefore, for active managers and the index fund, I have used as a guideline the pretax and after-tax returns provided by Morningstar for the 10-year period ending 30 April 2013.

Over this period, the total stock market index had an average annual return of 8.7%. The return for actively managed large-cap blend funds was 7.5%, of which about 75 bps was lost to taxes; the broad market index fund lost about 30 bps to taxes.⁸ So, I will use a conservative and rounded tax differential estimate of 45 bps, which likely understates the extra tax costs incurred by investors in actively managed funds. With taxes considered, the total all-in costs added by actively managed mutual funds amount to about 317 bps per year for taxable investors (Table 3).

This rough snapshot of the annual impact of taxes may suggest that tax costs are inconsequential. But when compounded over 40 years (as in the previous example), they bring the extra costs of actively managed funds to a truly overwhelming annual level of 3.02%. In Figure 1, I assume that a taxable fund investor begins with a \$10,000 investment in (1) a tax-efficient index mutual fund and (2) a tax-inefficient actively managed fund and simply holds each for the subsequent four decades.

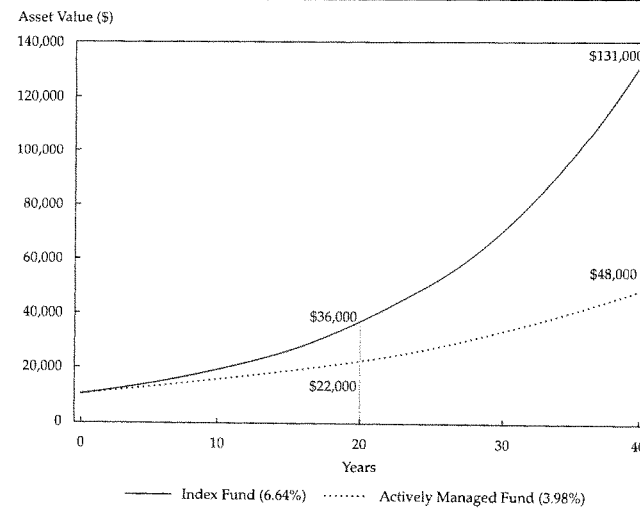
The calculated terminal value of the active fund grows steadily over time—\$15,000 after 10 years, \$22,000 after 20 years, and \$48,000 after 40 years. The index fund grows far more swiftly, ending up with a value of \$131,000, a remarkable enhancement of \$83,000, or almost 175%. Indeed, taxes are a vital consideration.⁹

Table 3. All-In Fund Costs Including Tax Differential, 10 Years Ending 30 April 2013

	Actively Managed Fund	Index Fund	Index Advantage
Assumed stock market return	7.00%	7.00%	—
All-in costs (from Table 1)	2.27	0.06	2.21%
Tax inefficiency	0.75	0.30	0.45
Total costs ^a	3.02	0.36	2.66
Assumed net fund return	3.98	6.64	2.66

^aHere, costs (including taxes) consume 43% of the returns for the active funds, compared with 5% for the index fund.

Figure 1. Growth of a \$10,000 Investment Based on All-In After-Tax Costs, Assuming a 7% Gross Annual Return on Stocks



Real vs. Nominal Returns

So far, I have reported fund returns on a *nominal* basis, unadjusted for the impact of inflation. But investors must rely on *real* returns to maintain their standard of living. Although mutual funds almost exclusively report only their nominal returns, I believe that fund investors must consider their real returns as well. Making this adjustment has an important negative impact on both active funds and index funds.

For example, if we assume a future annual rate of inflation of only 2%—the approximate present spread between the inflation-adjusted 10-year Treasury Inflation-Protected Security and the 10-year US Treasury note itself—it reduces the assumed nominal annual market return of 7% to a real return of 5%. Thus, the real return after all-in costs for actively managed funds would fall to 1.98% from its nominal 3.98%, and the index fund real return would fall to 4.64% from a nominal return of 6.64%.¹⁰ Compounded over 40 years, a \$10,000 initial investment in active funds would grow to just \$22,000 in real terms whereas the index fund would grow to \$61,000—a nearly threefold enhancement. These numbers may be scary and almost unbelievable, but the data do not lie.

Counterproductive Investor Behavior

Throughout this article, I have presented the returns as reported by the mutual funds themselves—essentially, the percentage change in the funds' net asset values, adjusted for the reinvestment of all dividends and distributions. As the record makes clear, however, mutual fund investors are too often tempted to add to their equity holdings when markets are rising, to withdraw their investments when markets tumble, and to move into funds that have performed well in the recent past only to revert to the mean (or below) thereafter. Such counterproductive investor behavior proves to be another advantage for index fund investors.

For example, over the 15 years ending 30 June 2013,¹¹ the actively managed large-cap blend funds evaluated by Sharpe (2013) reported an average annual return of 4.50%—for the funds that survived the period. But Morningstar calculated that the asset-weighted return earned by investors over the same period was just 2.59%, a "behavior gap" of 1.91 percentage points in return per year. (As it happens, in this particular period, investors in the Total Stock Market Index Fund exhibited moderately productive timing, earning a slightly higher annual return than the fund reported.) A loss of almost 2 more percentage points of annual return for active investors—over and above fund expense

ratios, other costs, and taxes—is a high penalty to pay for the combination of high costs and counterproductive movement of their money from one fund to another.¹²

Reconciliation

Now I will explore how consistent these all-in cost estimates are with the returns earned by large-cap equity funds relative to the returns earned by the Total Stock Market Index Fund. First, let us assume, as so many academic studies indicate, that active equity mutual funds as a group provide, before costs, a return equal to that of the stock market itself at the same level of risk ("zero alpha"). Therefore, the subtraction of direct all-in fund expenses should essentially reflect the difference between the market return and the managed fund return. The exercise is a bit complex because some of the expenses I have reviewed so far are internal to the funds themselves and others are paid directly by the fund investors. Table 4 should clarify this distinction.

The concept is that the net returns achieved by large active funds should lag the returns earned by the Total Stock Market Index Fund by the amount of direct costs paid out of fund gross returns—1.77 percentage points annually. The costs of sales and distribution fees, extra taxes, and imprudent (or opportunistic) investment behavior—another 2.15 percentage points in aggregate—are not included here because they are borne directly by the investors themselves. How does that theory work in practice? Quite nicely, as it turns out. For example, over the two decades ending 31 December 2012, the average actively managed large-cap core fund earned a compound annual return of 6.50% (adjusted for survivorship bias, as described later in this section), falling short of the 8.3% return of the Total Stock Market Index Fund by 1.80 percentage points per year. That shortfall is remarkably close to the annual differential between index fund

Table 4. Allocation of Costs of Actively Managed Funds (from Tables 1 and 2)

	Costs Borne by Fund	Costs Borne by Investor
Expense ratio	1.12%	—
Transaction costs	0.50	—
Cash drag	0.15	—
Sales charges	—	0.50%
Tax inefficiency	—	0.45
Investor behavior	—	1.20 ^a
Total	1.77%	2.15%

^aA conservative estimate, well below the 1.91 percentage point lag realized over the past 15 years.

direct costs and active fund direct costs of 1.77 percentage points, as shown in Table 4.

This near precision, I must report, is no more than a happy coincidence, simply because the calculations of costs and returns presented in this article are, as noted earlier, inevitably imprecise. Even a larger difference in the results for the past two decades—say, plus or minus 50 bps—would nonetheless confirm the strong relationship between fund costs and fund returns. The costs are based on the results over the past two decades, using limited data and some experienced judgment. Therefore, take this fragile precision only as proof, in principle, that the influence of costs must dominate the relationship between the returns earned by active funds and the returns earned by index funds.

One of the principal challenges in calculating the average returns of the funds is the need to eliminate what is called “survivorship bias”—that is, to take into account not only the returns of funds that survived a given period but also those that failed to do so. Obviously, data that are not free of survivorship bias are inappropriate (after all, funds with poor records are less likely to survive), but there are myriad methods of calculating the difference. I have found the data provided by Lipper to be quite reliable. Using its data for the two decades ending 31 December 2012, for example, the *surviving* large-cap core funds earned an annual return of 7.86%. But, as shown above, all the funds in that category, including those that did not survive, earned only 6.50%, or 1.36 percentage points less. Given the persistent high failure rate of equity mutual funds,¹³ this adjustment for survivorship bias is essential.

Earlier studies of the relative returns of actual mutual funds and the broad market indices confirm the reasonableness of these estimates of the impact of direct costs incurred by investors. For example, in his book *Unconventional Success: A Fundamental Approach to Personal Investment*, Yale endowment fund manager David Swensen (2005) summarized research conducted by Robert Arnott, Andrew Berkin, and Jia Ye and reported that for the 20 years ending 31 December 1998, the average actively managed fund underperformed a broad stock market index fund by 2.1 percentage points per year before taxes. (Numerous other studies confirm a spread in this range.) Current data also confirm a shortfall of this magnitude. As noted earlier in this

section, over the 20 years ending 31 December 2012, the underperformance of the active funds relative to the index was almost identical—1.8 percentage points per year. Broadly speaking, *the reality confirms the theory*.

Conclusion

By examining mutual fund expense ratios, Dr. Sharpe began the saga of how much the draining impact of expense ratios erodes the returns delivered to fund investors over the long term. My analysis in this article builds on that foundation, but I estimated the *all-in* costs incurred by mutual funds—expense ratios *plus* the other fund costs—which are numerous and substantial in the case of actively managed funds but far less numerous and less substantial for index funds. It is simply a story that must be told.

I re-emphasize the inevitable imprecision of my data, even as I reiterate that I have tried to use conservative estimates—selecting the lowest reasonable number in each case and, in all likelihood, understating the confiscatory impact of the additional transaction costs, cash drag, sales loads, distribution costs, tax inefficiency, and counterproductive investor behavior. Others will no doubt find fault with my data and estimates, and I urge industry participants and academics alike to offer constructive criticism of my data, including their own estimates of these costs.

I also urge mutual fund investors not only to consider the conventional *annual* impact of expense ratios and other costs but also to recognize how much these differences matter as time horizons lengthen. In the short term, the impact of costs may appear modest, but over the long run, investment costs become immensely damaging to an investor's standard of living. *Think long term!* For those who are investing for their retirement and for their lifetimes, understanding the cost issue is vital to success in investing. An increase of 65% in the wealth accumulated by retirement plan investors is not trivial! After analyzing the data over many years, I feel confident in reaffirming the warning that I have consistently given to fund investors over the years: *Do not allow the tyranny of compounding costs to overwhelm the magic of compounding returns.*

This article qualifies for 0.5 CE credit.

Notes

1. Sharpe's assignment of the “burden of proof” to fund managers echoes Paul Samuelson's “Challenge to Judgment” (1974). In that article, he demanded “brute evidence” of the superiority of active management. As far as we know, no such evidence was ever produced.

2. These turnover measures represent the total portfolio purchases and sales of equity funds each year as a percentage of assets, not the traditional—albeit inexplicable—formula that is in general use today: the lesser of purchases and sales as a percentage of assets. My recent speech “Big Money

- in Boston—The Commercialization of the 'Mutual' Fund Industry" details my methodology and is available at www.johnnbogle.com.
3. Investment Company Institute, 2013 *Investment Company Fact Book*, 53rd ed. (2013, p. 86, Figure 5.11).
 4. Strategic Insight, "The Strategic Insight 2012 Fund Sales Survey: Perspectives on Intermediary Sales by Distribution Channel and by Share Class" (May 2013, p. 27).
 5. In Table 2, I provide a footnote that illustrates the impact on the returns of index funds assuming the same 50 bp distribution cost estimate used for active funds.
 6. It seems likely that many corporate DC plans (especially those with substantial assets) would fall on the lower side of the 50 bp distribution cost estimate, whereas most IRAs (which cannot take advantage of the economies of scale available to large DC plans) would fall on the higher side.
 7. Investment Company Institute, 2013 *Investment Company Fact Book*, 53rd ed. (2013, p. 114, Figure 7.4).
 8. The loss to taxes by active funds is *increased* by the capital gains realized by their high turnover but *reduced* by their high expense ratios, which consume almost 60% of their dividend income. (For 2012, gross dividend yield was 2.1%, the average expense ratio was 1.2%, and the net taxable yield was 0.9%.) In contrast, the low turnover of the index fund leads to a far *smaller* capital gain tax burden, but its low expense ratio, 0.06%, confiscates only 3% of income, leaving its 2.1% gross yield barely impaired.
 9. Note that taxes on both the active funds and the index fund are based on "pre-liquidation, after-tax returns" as provided by Morningstar. That is, each fund is assumed to be held through the end of the period. On a post-liquidation basis (i.e., when sold at the end of the period), the index fund advantage still exists but is smaller.
 10. Again, relative to the assumed *real* return on stocks of 5%, active fund costs would consume 60% of the return, compared with 7% of the return of the index fund.
 11. As of this writing, this is the date of the most recent and comprehensive available Morningstar data on investor returns.
 12. Alas, even the 1.98% real return for investors in actively managed equity funds is *before* the (conservative) estimate of 1.20% lost annually to counterproductive investor behavior. I leave it to the reader to do the subtraction.
 13. A recent study by Vanguard found that of 1,540 managed US equity funds in 1998, only 842 survived through 2012, or barely 55% of those in existence at the beginning of the period. In addition, only 275, or 18% of the total, both survived *and* outperformed their benchmarks—further confirmation of the proven success of index funds.

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INVESTING

The Incredibly Shrinking Financial System

John C. Bogle argues that investors will continue to turn their backs on active management and speculation

ONE MAJOR PRINCIPLE HAS SHAPED MY 63-year career in investments: "When there is a gap between perception and reality, it is only a matter of time until reality takes over." In considering the future of investing over the coming decades, that's a good place to begin. So what's ahead?



Mr. Bogle is the founder and former chairman and chief executive officer of Vanguard Group.

1. A MUCH SMALLER FINANCIAL SYSTEM.

Investors will increasingly "see the light" and choose low-cost, low-turnover, middle-of-the-road strategies, buying and holding their investment portfolios for the long term. The reality is that hyperactive trading strategies offer incomprehensible complexity that ultimately destroys value. As investors continue to favor value-creating simplicity, and realize that their positive perception of finance conflicts with that reality, they will demand a smaller and less-costly financial system.

Today, our nation's financial system is generally perceived as a smoothly functioning national asset. But the reality is that its cost has soared from a low of 4% of gross domestic product in 1950 to an estimated 10% of GDP in 2013—\$1.6 trillion.

The wealth generated for the system's insiders—senior financial executives, mutual-fund managers, hedge-fund operators, entrepreneurs and financial buccaners—has grown to epic levels.

Simply put, I predict that the wealth arrogated to itself by our bloated financial system will be rejected by the largest set of participants in finance—our investors.

2. A MARKED DECLINE IN SPECULATION.

As investors come to recognize the long-term financial penalty of excessive trading activity, they will begin to demand their fair share of the value created by our publicly traded corporations. The perception held by too many investors that they can beat the market will give way to the reality that, on balance, trading grotesque trillions of dollars with one another—last year alone, a record \$56 trillion—is to no avail.

In fact, America's corporations are the true value creators. Wall Street firms, with their excessive intermediation costs, are value destroyers. Investors are simply the residual beneficiaries. That's the ultimate reality. The perception that short-term speculation can add value will fade, if only slowly.

3. A GROWING DISTRUST OF ACTIVE MANAGERS.

Looking ahead, the trend of investors moving away from actively managed mutual funds and toward passive index funds will strengthen. Index funds now account for 34% of U.S. equity mutual-fund assets. Since 2007, investors have added \$930 billion to their investments in passively operated U.S. equity index funds, and they have withdrawn \$240 billion from their holdings in actively managed equity funds. That's a swing of more than \$1.17 trillion in investor preferences. In the years ahead, that trend will accelerate.

The "secret" of the traditional index fund is a combination of low cost, broad diversification and a long-term horizon. Investors can enjoy the magic of compounding long-term returns, while avoiding the severe penalty inflicted by compounding costs. Broad-market index funds can cost as little as 0.05% a year, compared with the 1% to 2% annual drag from the costs of active management.

As investors increasingly see the benefits of the index fund, their perception that active fund managers as a group are able to add value will fade. In the coming era, active managers will have to make hard choices about their fees, their strategies, their portfolio turnover, their tax inefficiency, and their susceptibility to large capital inflows—and outflows—depending on their returns.

4. THE RISE OF CORPORATE GOVERNANCE.

Over the coming decades, institutional money managers will become far more active in engaging the managements of the corporations whose shares are held in their portfolios. The perception is that the giant money managers that dominate today's intermediation society represent a powerful force in corporate governance. The reality is that their latent power remains unexercised. For

example, asset managers regularly endorse management's nominees for directors and shy away from supporting proxy proposals by minority shareholders.

Both our corporate and financial manager/agents have too often placed their own interests before the interests of their shareholder/principals. We now operate in an unprecedented "double agency" society, a tacit conspiracy between these two sets of agents—corporate managers, and institutional asset managers—leaving our system of capitalism largely bereft of the checks and balances demanded by elementary principles of sound governance.

The 300 largest institutional money managers—largely mutual funds and pension funds—now own some 65% of all U.S. stocks by market capitalization. (The largest 10 managers alone own 32%.) They therefore hold absolute power over our nation's corporations, a share that is likely to increase over time. That largely unexercised power will be exercised in the coming era, aided by a federal standard of fiduciary duty for these trustees of Other People's Money. As we become a Fiduciary Society, our corporate and financial system will finally place first the interests of investors.

In 1949, writing in "The Intelligent Investor," Benjamin Graham said that, in theory, "stockholders as a class are king. Acting as a majority they can hire and fire managements and bend them completely to their will." The behavior of stockholders has long suggested that such power is largely theoretical. But I predict that it must—and will—become a reality in the years ahead, as institutional investors are forced to recognize not only their rights, but their responsibilities of corporate ownership and control.

The four changes that I've outlined here are coming. The financial system will shrink in relative importance; much of today's short-term speculation will gradually be displaced by long-term investment; index funds will rise and active management will fall; and public opinion and public policy will together demand that the managers of Other People's Money act as good corporate citizens.

These challenges to the status quo will be fought aggressively by entrenched special interests of the financial sector. But when investors demand change, money managers will, in their own self-interest, accede to their wishes. After all, as Adam Smith wrote in 1776, the interest of the consumer must be the ultimate end and object of all industry and commerce. In the world of investing, Adam Smith's maxim will finally become reality.



September 16, 2014

Hatch Statement at Finance Hearing on Retirement Savings

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing on retirement savings:

Thank you Mr. Chairman for holding today's hearing.

This is an important topic and we have an outstanding panel of witnesses. I think that we're going to have a very interesting discussion.

Retirement policy has always been an especially important topic to this committee. It also has always been bipartisan.

Most of the major pieces of retirement legislation that Congress has passed in recent decades have been named for Senators from this committee – one from each party. I'm talking, of course, about legislation like Bentsen/Roth; Roth/Breaux; Grassley/Bob Graham; Grassley/Baucus and Hatch/Pryor, which, in the other body, came to be known as Portman/Cardin, for the two excellent legislators that I am proud to say are now colleagues of ours on this committee.

I believe this tradition of bipartisanship on these issues can and will continue.

Mr. Chairman, during the recent Highway Bill markup, we agreed to work together on multiemployer pension reform. That was done in the spirit of bipartisanship. And, I have a pension reform bill for the modern economy that just last week received high marks from the Urban Institute that I hope you'll work on with me as well.

It is my sincere hope that the tradition of bipartisanship in retirement policy will continue and that the next retirement bill that comes out of this committee and becomes law will be known as Wyden/Hatch.

We have always had incentives in the tax code to encourage saving for retirement. As the late Chairman Roth was known for saying: "There are no bad savings."

Congress has revisited saving incentives on occasion with an eye toward improving the incentives and increasing savings.

For example, in 2001 Congress increased the limits for contributions to 401(k) plans so that today a worker may contribute \$17,500 to a 401(k) and \$5,000 to an IRA. Congress also added a "catch-up" contribution feature to the Code to allow workers to contribute several thousand dollars more beginning in their 50s, an age when many workers finally get serious about saving and when workers, including spouses, primarily women, who might have left the workforce for a time finally have the opportunity to save again.

As reported in the Bluebook published at the time by the Joint Committee on Taxation, Congress believed it was important to increase the amount of employee elective deferrals allowed under such plans, and other plans that allow deferrals, to better enable plan participants to save for their retirement.

Well, it worked. Since 2000, retirement assets in defined contribution plans have grown from \$3 trillion to nearly \$6 trillion, despite the market downturn in 2008. Assets in IRAs have grown from \$2.6 trillion to \$6.5 trillion. In fact, increased contribution limits worked so well that, in 2006, Congress made those provisions permanent, and the vote to make them permanent was overwhelming: 93 to 5.

The retirement policies we have pursued have always been about helping Americans help themselves save more of their hard-earned money, not less.

In the last 25 years Democrats and Republicans have worked together to respond to a mutually-shared goal: expanding savings among workers. Republicans agreed to proposals targeted to lower income workers like the savers credit. Democrats agreed that small business owners and managers needed to have some tax benefit skin in the game to take on the burdens of adopting and maintaining retirement plans.

In these areas, members from both parties have resisted partisan impulses and, as a result, we've been able to craft good policy.

Lately, however, I've become concerned that there is a political strategy by some in Congress to turn pension policy into just another partisan battleground. They would turn retirement policy into another front in the class warfare that consumes so much energy on some of the other committees in Congress.

I'm worried that some want to disregard the bipartisan good will of the last 25 years.

That would be unfortunate. I especially hope it does not happen in our hearing today.

Mr. Chairman, what I hope to hear today from the witnesses are facts that can inform our policy considerations. We need to know how much income Americans are projected to need in retirement, how much are they projected to have and, if there is a shortfall, what policies they recommend we enact to help Americans close the gap.

What I hope to not hear today are poll-tested slogans like "Upside Down Tax Incentives," "Bang for the Buck," "Pension Stripping," or "The System is Rigged" without substantiating data. We need to hear facts and serious policy proposals, not political slogans.

Thank you, once again, Mr. Chairman for holding this hearing.

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United States Senate

COMMITTEE ON FINANCE
 WASHINGTON, DC 20510-6200

September 30, 2014

The Honorable Ron Wyden
 Chairman
 U.S. Senate Committee on Finance
 219 Dirksen Senate Office Building
 Washington, D.C. 20510

Mr. Chairman,

During the Senate Finance Committee's September 16th hearing on retirement security titled "Retirement Savings 2.0: Updating Savings Policy for the Modern Economy," statements were made to the effect that tax incentives for Individual Retirement Accounts (IRAs) are "out of whack" and that IRAs have become a "tax shelter for millionaires." As evidence for this view, selected preliminary data from a Government Accountability Office (GAO) report, that has not yet been made public, was submitted for the record.

The preliminary data show that of an estimated 43 million taxpayers with IRAs, the GAO is 95% confident that between 115 and 650 taxpayers have IRA account balance in excess of \$25 million—quite an imprecise estimate. The "fair market value" of balances held in those accounts, according to GAO estimates, could, with 95% confidence, be anywhere between \$8 billion and \$225 billion. Basing any policy decision on such fragile estimates would leave a lot to be desired.

Further, GAO's submission for the record, and the testimony of Dr. Brigitte C. Madrian, both conclude that it is not possible for a taxpayer to accumulate such a large IRA account balance solely by making the maximum annual contribution permitted by the tax code and earning average investment returns. Large balance IRAs are not the result of current law contribution limits to IRAs and 401(k) plans or rollovers to IRAs from 401(k)s. Rather, IRA account balances that great must be the result of other factors, such as extraordinary investment success on the part of the taxpayer.

Nevertheless, it appears that some believe that the retirement savings system should be changed to lower the maximum annual IRA or 401(k) contribution taxpayers in upper income groups may make to help save for retirement, under a mistaken notion that the tax incentive for

IRA retirement savings is skewed toward the wealthy. Of course, the GAO's preliminary findings suggest no such thing but, rather, merely identify that there is an imprecisely estimated small number of IRA account holders who experienced returns in their accounts above market averages.

Congress has never judged the policy success of specific "tax expenditures," which is what some view 401(k) and IRA savings to be, solely on a distributional skewness basis. If that were the case, we certainly would not look to the IRA "tax expenditure." As the attached tables from the Joint Committee on Taxation and Congressional Budget Office (CBO) demonstrate, the "tax expenditure" for IRAs distributes overwhelmingly to middle class taxpayers.

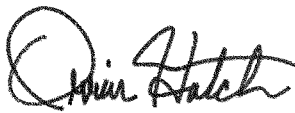
Moreover, of the ten tax expenditures analyzed by the CBO in the attached report, there are several with distribution patterns skewed to taxpayer groups with far higher incomes than IRA owners. For example, the state and local income tax deduction and the tax exempt interest exclusion are overwhelmingly concentrated among high income taxpayers.

It is certainly true that successful investment returns for an IRA owner *after* the legally permitted contribution has been made can lead to above-average IRA balances. But there is no sound policy justification for punishing taxpayers merely for successful investment results. In fact, in 1997 Congress repealed an excise tax on "excess" retirement accumulations. As set forth in the JCT Bluebook that year, Congress determined that limits on contributions were a sufficient limitation on tax-deferred savings and that additional penalties were not necessary and may deter individuals from saving.

The excess retirement accumulation tax was repealed, with bipartisan support, because it inappropriately penalized favorable investment returns. Penalizing favorable investment returns is a policy to which Congress should not return.

In short, it is my firm belief that the tax incentives for retirement savings are not "out of whack" or "upside down." The tax expenditure related to IRAs is demonstrably not skewed toward upper income taxpayers.

Sincerely,

A handwritten signature in black ink, appearing to read "Orrin Hatch", written over a horizontal line.

Orrin G. Hatch
Ranking Member
Senate Committee on Finance

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515-6453

SEP 07 2012

MEMORANDUM

TO: Mark Prater and Aaron Taylor
FROM: Thomas A. Barthold *TAB*
SUBJECT: Distribution of Tax Expenditure Estimates

This memorandum is a partial response to your request of August 28, 2012, for a distribution of all individual tax expenditure estimates. This memorandum provides a distribution by income class, including at \$200,000 of expanded income and above, of several individual tax expenditures. It does not provide information by income quintile. In the distribution tables, the \$200,000 breakpoint corresponds to approximately the 96th percentile of all filing units in 2010 (the top four percent), excluding individuals who are dependents and taxpayers with negative income.

The staff of the Joint Committee on Taxation routinely reports distribution information for various tax expenditures in its annual publication on the subject, the most recent edition of which was published on January 17, 2012.¹ The tax expenditures for which distribution information is routinely provided include: (1) medical expenses deduction; (2) real estate tax deduction; (3) State and local income, sales, and personal property tax deduction; (4) charitable contributions deduction; (5) child care credit; (6) earned income credit; (7) exclusion of social security and railroad retirement benefits; (8) child tax credit; (9) education credits; (10) student loan interest deduction; (11) mortgage interest deduction; and (12) phase out of the personal exemption for regular income tax and denial of the personal exemption and the standard deduction for the alternative minimum tax. The tables from our most recent publication, reproduced below, provide distribution information at 2010 tax rates and 2010 income levels.

The additional tables below provide distributional estimates by income class at 2011 tax rates and 2011 income levels for the following additional individual tax expenditures: (1) exclusion of interest on tax-exempt bonds;² (2) reduced rates of tax on long-term capital gains; (3) reduced rates of tax on qualified dividends; (4) exclusion of employer provided health benefits and the deduction for self-employed health; (5) exclusion of employer and employee

¹ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015* (JCS-1-12), January 17, 2012.

² These calculations were produced using tax exempt interest reported by individuals on Form 1040. Since this line is not used for calculation of income tax liability it is likely underreported. Therefore, totals cannot be compared directly to totals for the tax expenditures for tax-exempt bonds. The distribution of the benefits reported here is similar to the distribution of all tax-exempt interest if the likelihood of underreporting is unrelated to income.

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515-6453

TO: Mark Prater and Aaron Taylor
SUBJECT: Distribution of Tax Expenditure Estimates

Page 2

contributions to defined contribution plans; and (6) deduction for traditional individual retirement arrangements.

Not included below are estimates of all other individual tax expenditure items. Among the fifteen largest individual income tax expenditures, ten are included above. The five that are not included are: (1) net exclusion of pension contributions and earnings, defined benefit plans; (2) exclusion of capital gains at death; and (3) exclusion of benefits provided under cafeteria plans; (4) exclusion of Medicare benefits; and (5) exclusion of investment income on life insurance and annuity contracts. Because reliable data are not available for these, and approximately 50 other exclusions, we are unable to provide distributional information for these items at this time.

Dozens of items are not listed in the tables in the annual tax expenditure tables because the estimated revenue losses are below the *de minimis* amount (\$50 million over five years). Several others are not listed because the projected revenue changes, and therefore any distribution of such amounts, are unavailable. A complete listing of these provisions may be found on pages 27 to 30 of our most recent tax expenditure publication.

Attachments: Tables #12-2 133, #12-2 134, and #12-2 138

**Distribution by Income Class of All Returns, Taxable Returns, Itemized Returns, and Tax Liability
at 2010 Rates and 2010 Law and 2010 Income Levels [1]**
[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	All Returns [3]	Taxable Returns	Itemized Returns	Tax Liability
Below \$10,000	20,836	14	425	-\$11,209
\$10,000 to \$20,000	17,294	2,063	735	-30,443
\$20,000 to \$30,000	18,357	5,302	1,289	-19,686
\$30,000 to \$40,000	15,190	6,618	2,092	-6,334
\$40,000 to \$50,000	13,391	7,932	3,030	6,193
\$50,000 to \$75,000	25,409	17,830	8,102	53,237
\$75,000 to \$100,000	16,276	14,492	7,498	74,335
\$100,000 to \$200,000	22,573	22,068	16,136	256,670
\$200,000 and over	5,956	5,909	5,583	509,106
Total	155,282	82,226	44,892	\$831,869

[1] Tax law as in effect on December 31, 2010, is applied to the 2010 level and sources of income and their distribution among taxpayers.

[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

[3] Includes filing and non-filing units. Filing units include all taxable and nontaxable returns. Non-filing units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.). Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

NOTE--Details may not add to totals due to rounding.

Source: Joint Committee on Taxation

Distribution by Income Class of Selected Individual Tax Expenditure Items,
at 2010 Rates and 2010 Income Levels [1]

[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	Medical Deduction		Real Estate Tax Deduction	
	Returns	Amount	Returns	Amount
Below \$10,000	219	[3]	--	--
\$10,000 to \$20,000	329	\$23	142	\$22
\$20,000 to \$30,000	584	86	382	73
\$30,000 to \$40,000	1,022	212	970	220
\$40,000 to \$50,000	1,297	458	1,864	464
\$50,000 to \$75,000	2,541	1,768	6,002	2,281
\$75,000 to \$100,000	1,840	1,961	6,452	3,092
\$100,000 to \$200,000	1,786	3,452	14,228	11,873
\$200,000 and over	155	933	2,815	4,946
Total	9,773	\$8,893	32,853	\$22,971

Footnotes appear at the end of the table.

Distribution by Income Class of Selected Individual Tax Expenditure Items,
at 2010 Rates and 2010 Income Levels [1] -- Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	State and Local Income, Sales, and Personal Property Tax Deduction		Charitable Contributions	
	Returns	Amount	Returns	Amount
Below \$10,000	6	--	[4]	[3]
\$10,000 to \$20,000	181	\$7	90	\$8
\$20,000 to \$30,000	667	41	379	59
\$30,000 to \$40,000	1,434	147	820	167
\$40,000 to \$50,000	2,397	340	1,616	339
\$50,000 to \$75,000	7,694	2,042	5,467	1,781
\$75,000 to \$100,000	7,698	3,093	5,927	2,519
\$100,000 to \$200,000	15,945	14,316	14,157	10,228
\$200,000 and over	3,745	19,409	5,199	21,170
Total	39,766	\$39,395	33,656	\$36,270

Footnotes appear at the end of the table.

Distribution by Income Class of Selected Individual Tax Expenditure Items,
at 2010 Rates and 2010 Income Levels [1] -- Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	Child Care Credit		Earned Income Credit [5]	
	Returns	Amount	Returns	Amount
Below \$10,000	---	---	5,985	\$7,192
\$10,000 to \$20,000	154	\$37	7,661	20,871
\$20,000 to \$30,000	710	381	5,146	15,125
\$30,000 to \$40,000	719	462	4,144	9,620
\$40,000 to \$50,000	541	298	2,870	5,034
\$50,000 to \$75,000	1261	671	2,089	2,761
\$75,000 to \$100,000	1091	593	89	122
\$100,000 to \$200,000	1543	853	5	4
\$200,000 and over	322	163	---	---
Total	6,341	\$3,458	27,989	\$60,729

Footnotes appear at the end of the table.

Distribution by Income Class of Selected Individual Tax Expenditure Items,
at 2010 Rates and 2010 Income Levels [1] -- Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	Untaxed Social Security and Railroad Retirement Benefits		Child Tax Credit [5]	
	Returns	Amount	Returns	Amount
Below \$10,000	2	[3]	2,233	\$1,195
\$10,000 to \$20,000	747	\$237	4,938	5,748
\$20,000 to \$30,000	4,089	1,463	4,545	6,498
\$30,000 to \$40,000	3,930	3,923	4,034	6,483
\$40,000 to \$50,000	3,578	5,120	3,445	5,913
\$50,000 to \$75,000	7,728	10,178	6,366	11,337
\$75,000 to \$100,000	4,841	6,127	4,600	8,195
\$100,000 to \$200,000	4,324	1,813	6,802	10,591
\$200,000 and over	902	411	36	25
Total	30,141	\$29,272	36,999	\$55,985

Footnotes appear at the end of the table.

Distribution by Income Class of Selected Individual Tax Expenditure Items,
at 2010 Rates and 2010 Income Levels [1] -- Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	Education Credits		Student Loan Interest Deduction	
	Returns	Amount	Returns	Amount
Below \$10,000	192	\$166	7	[3]
\$10,000 to \$20,000	662	397	200	\$14
\$20,000 to \$30,000	852	684	400	43
\$30,000 to \$40,000	759	743	652	78
\$40,000 to \$50,000	795	790	704	94
\$50,000 to \$75,000	1,632	1,741	1,659	290
\$75,000 to \$100,000	1,416	1,589	1,190	159
\$100,000 to \$200,000	1,945	2,484	2,099	426
\$200,000 and over	86	65	--	--
Total	8,340	\$8,660	6,911	\$1,104

Footnotes appear at the end of the table.

Distribution by Income Class of Selected Individual Tax Expenditure Items,
at 2010 Rates and 2010 Income Levels [1] -- Continued
[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	Mortgage Interest Deduction		Phase out of Personal Exemption for Regular Income Tax, and Denial of Personal Exemption and the Standard Deduction for AMT	
	Returns	Amount	Returns	Amount
Below \$10,000	[4]	[3]	[4]	[6]
\$10,000 to \$20,000	196	\$63	[4]	[6]
\$20,000 to \$30,000	481	258	[4]	[6]
\$30,000 to \$40,000	985	654	[4]	[6]
\$40,000 to \$50,000	1,797	1,324	[4]	[6]
\$50,000 to \$75,000	5,750	6,855	22	-\$13
\$75,000 to \$100,000	5,966	8,748	58	-52
\$100,000 to \$200,000	13,932	35,609	587	-745
\$200,000 and over	4,575	29,142	3,279	-8,735
Total	33,682	\$82,654	3,947	-9,546

[1] Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

[3] Positive tax expenditure of less than \$500,000.

[4] Fewer than 500 returns.

[5] Includes the refundable portion.

[6] Negative tax expenditure of less than \$500,000.

NOTE--Details may not add to totals due to rounding.

Source: Joint Committee on Taxation

Distribution by Income Class of Selected Individual Tax Expenditure Items
2011 Rates and 2011 Income Levels [1] [2]
[Returns in Thousands; Amounts in Millions]

	Tax-Exempt Bond Interest [3]	
	Returns	Amount
Below \$10,000	2	\$1
\$10,000 to \$20,000	14	\$2
\$20,000 to \$30,000	45	\$6
\$30,000 to \$40,000	84	\$16
\$40,000 to \$50,000	263	\$88
\$50,000 to \$75,000	918	\$548
\$75,000 to \$100,000	991	\$718
\$100,000 to \$200,000	2,008	\$2,288
\$200,000 to \$500,000	1,088	\$2,996
\$500,000 to \$1,000,000	276	\$1,702
\$1,000,000 and above	204	\$5,297
TOTAL	5,893	13,661

	Long-Term Capital Gains	
	Returns	Amount
Below \$10,000	[4]	[5]
\$10,000 to \$20,000	98	\$13
\$20,000 to \$30,000	186	\$54
\$30,000 to \$40,000	332	\$91
\$40,000 to \$50,000	596	\$215
\$50,000 to \$75,000	1,837	\$962
\$75,000 to \$100,000	1,837	\$1,338
\$100,000 to \$200,000	3,422	\$3,955
\$200,000 to \$500,000	1,270	\$4,882
\$500,000 to \$1,000,000	223	\$4,500
\$1,000,000 and above	138	\$39,910
TOTAL	9,939	\$5,918

Distribution by Income Class of Selected Individual Tax Expenditure Items
2011 Rates and 2011 Income Levels [1] [2]
[Returns in Thousands; Amounts in Millions]

	Qualified Dividends	
	Returns	Amount
	2	[4]
Below \$10,000	189	\$12
\$10,000 to \$20,000	375	\$42
\$20,000 to \$30,000	787	\$88
\$30,000 to \$40,000	1,377	\$225
\$40,000 to \$50,000	4,294	\$1,115
\$50,000 to \$75,000	4,324	\$1,147
\$75,000 to \$100,000	8,080	\$2,701
\$100,000 to \$200,000	2,987	\$2,040
\$200,000 to \$500,000	481	\$1,530
\$500,000 to \$1,000,000	265	\$6,307
\$1,000,000 and above	23,161	15,207
TOTAL	81,753	112,936

	Employer Provided Health Benefits and Deduction for Self-Employed Health [6]		
	Returns	Amount	FICA Change
Below \$10,000	1,974	-\$568	\$1,089
\$10,000 to \$20,000	4,486	-\$276	\$3,373
\$20,000 to \$30,000	6,341	\$3,233	\$5,806
\$30,000 to \$40,000	7,594	\$6,991	\$7,720
\$40,000 to \$50,000	7,901	\$8,447	\$9,194
\$50,000 to \$75,000	17,271	\$18,964	\$23,257
\$75,000 to \$100,000	12,517	\$15,370	\$20,729
\$100,000 to \$200,000	18,637	\$39,864	\$32,553
\$200,000 to \$500,000	4,285	\$17,674	\$5,076
\$500,000 to \$1,000,000	498	\$2,136	\$441
\$1,000,000 and above	251	\$1,101	\$217
TOTAL	81,753	112,936	109,455

Distribution by Income Class of Selected Individual Tax Expenditure Items
2011 Rates and 2011 Income Levels [1] [2]
[Returns in Thousands; Amounts in Millions]

	Employer and Employee Contributions to 401K Plans [6]		
	Returns	Amount	FICA Change
Below \$10,000	[5]	[4]	[4]
\$10,000 to \$20,000	205	\$6	\$7
\$20,000 to \$30,000	637	\$28	\$28
\$30,000 to \$40,000	1,673	\$340	\$105
\$40,000 to \$50,000	2,507	\$841	\$223
\$50,000 to \$75,000	3,074	\$1,469	\$362
\$75,000 to \$100,000	8,226	\$6,748	\$1,377
\$100,000 to \$200,000	7,124	\$8,469	\$1,760
\$200,000 to \$500,000	13,854	\$40,507	\$4,564
\$500,000 to \$1,000,000	3,512	\$27,870	\$1,407
\$1,000,000 and above	359	\$3,932	\$192
TOTAL	41,171	90,198	10,025

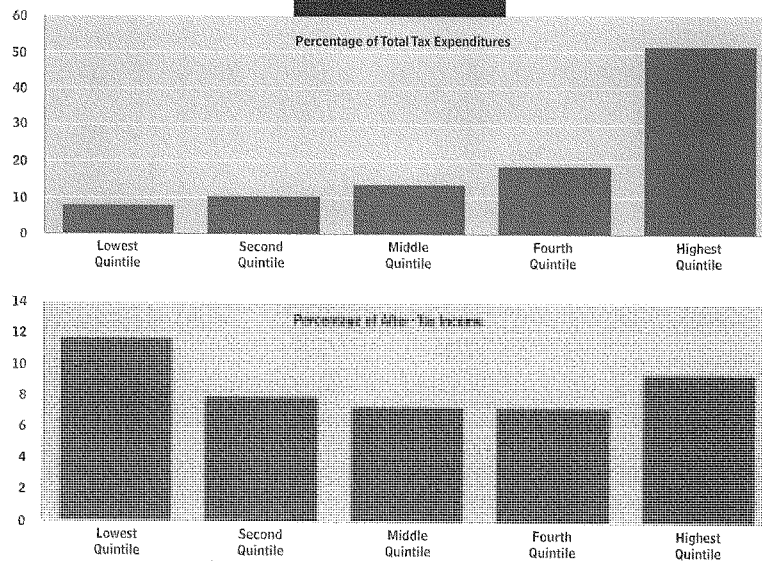
	Exclusion of Social Security and Railroad Retirement Benefits		
	Returns	Amount	[4]
Below \$10,000	3		
\$10,000 to \$20,000	753	\$246	
\$20,000 to \$30,000	4,077	\$1,491	
\$30,000 to \$40,000	3,915	\$4,023	
\$40,000 to \$50,000	3,754	\$5,409	
\$50,000 to \$75,000	8,244	\$10,868	
\$75,000 to \$100,000	5,213	\$6,652	
\$100,000 to \$200,000	4,042	\$1,728	
\$200,000 to \$500,000	681	\$311	
\$500,000 to \$1,000,000	92	\$44	
\$1,000,000 and above	55	\$27	
TOTAL	30,827	30,799	

Distribution by Income Class of Selected Individual Tax Expenditure Items
2011 Rates and 2011 Income Levels [1] [2]
[Returns in Thousands; Amounts in Millions]

	Deductions for Traditional IRAs	
	Returns	Amount
Below \$10,000	3	\$1
\$10,000 to \$20,000	67	\$32
\$20,000 to \$30,000	139	\$69
\$30,000 to \$40,000	189	\$110
\$40,000 to \$50,000	256	\$152
\$50,000 to \$75,000	718	\$558
\$75,000 to \$100,000	583	\$490
\$100,000 to \$200,000	934	\$1,082
\$200,000 to \$500,000	124	\$298
\$500,000 to \$1,000,000	18	\$50
\$1,000,000 and above	10	\$28
TOTAL	3,042	2,870

Details may not add to totals due to rounding.

- [1] Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.
- [2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.
- [3] These calculations were produced using tax exempt interest reported by individuals on Form 1040. Since this line is not used for calculation of income tax liability it is likely underreported. Therefore, totals can not be compared directly to totals for the tax expenditure for tax exempt bonds.
- [4] Positive tax expenditure of less than \$500,000.
- [5] Fewer than 500 returns.
- [6] Negative amounts reflect the fact that the exclusion reduces earned income for purposes of the earned income credit, resulting in a decrease in refundable credits for some recipients.

CBO**The Distribution of
Major Tax
Expenditures in the
Individual
Income Tax System**

Estimated Distribution of Major Tax Expenditures, by Income Group, 2013,
Including Forgone Income Tax and Payroll Tax Revenues

MAY 2013

Notes

Unless otherwise indicated, the years referred to in this report are calendar years.

Numbers in the text and tables may not add up to totals because of rounding.



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The Distribution of Major Tax Expenditures in the Individual Income Tax System

Summary

A number of exclusions, deductions, preferential rates, and credits in the federal tax system cause revenues to be much lower than they would be otherwise for any given structure of tax rates. Some of those provisions—in both the individual and corporate income tax systems—are termed “tax expenditures” because they resemble federal spending by providing financial assistance to specific activities, entities, or groups of people. Tax expenditures, like traditional forms of federal spending, contribute to the federal budget deficit; influence how people work, save, and invest; and affect the distribution of income.

This report examines how 10 of the largest tax expenditures in the individual income tax system in 2013 are distributed among households with different amounts of income.¹ Those expenditures are grouped into four categories:

■ Exclusions from taxable income—

- Employer-sponsored health insurance,
- Net pension contributions and earnings,
- Capital gains on assets transferred at death, and
- A portion of Social Security and Railroad Retirement benefits;

■ Itemized deductions—

- Certain taxes paid to state and local governments,
- Mortgage interest payments, and
- Charitable contributions;

■ Preferential tax rates on capital gains and dividends; and

■ Tax credits—

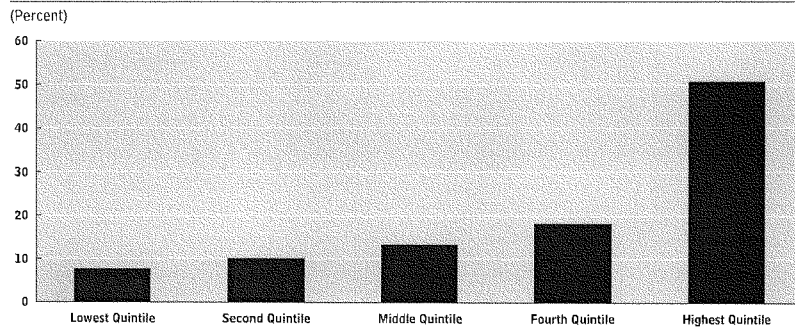
- The earned income tax credit, and
- The child tax credit.

Some of the provisions of law that reduce the amount of taxable income under the individual income tax also decrease the amount of earnings subject to payroll taxes. The figures presented in this report are generally based on the reduction in payroll taxes as well as the reduction in income taxes, but some figures separate those two effects. (Provisions that reduce payroll tax receipts generally reduce future Social Security benefits as well; that effect is not analyzed in this report.)

How Do Tax Expenditures Affect the Federal Budget?

Although the 10 major tax expenditures listed here represent a small fraction of the more than 200 tax expenditures in the individual and corporate income tax systems, they will account for roughly two-thirds of the total budgetary effects of all tax expenditures in fiscal year 2013, the Congressional Budget Office (CBO) estimates. Together, those 10 tax expenditures are estimated to total more than \$900 billion, or 5.7 percent of gross domestic product (GDP), in fiscal year 2013 and are projected to amount to nearly \$12 trillion, or 5.4 percent of GDP, over the 2014–2023 period. In addition,

1. The 10 tax expenditures examined in this report are the ones with the largest effects on individual income taxes in fiscal year 2013, except for the exclusion from taxable income of Medicare benefits, as discussed later. Although that group represents the largest tax expenditures in 2013, the size and composition of the largest tax expenditures change over time. In particular, subsidies for participation in health insurance exchanges that take effect beginning in 2014 are projected to be among the largest tax expenditures in later years.

Summary Figure 1.**Shares of Selected Major Tax Expenditures, 2013**

Source: Congressional Budget Office.

Notes: Quintiles, or fifths, are created by ranking households by their before-tax income. Quintiles contain equal numbers of people.

The selected major tax expenditures are the exclusion of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums; the exclusion of net pension contributions and earnings; the exclusion of capital gains on assets transferred at death; the exclusion of a portion of Social Security and Railroad Retirement benefits; the deduction for mortgage interest on owner-occupied residences; the deduction of nonbusiness state and local government income, sales, real estate, and personal property taxes; the deduction for charitable contributions; reduced rates on dividends and long-term capital gains; the earned income tax credit; and the child tax credit.

The expenditures for the exclusion of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums and for the exclusion of net pension contributions and earnings include the effect on payroll taxes. The expenditures for the earned income tax credit and the child tax credit include the effect on outlays.

Because estimates of tax expenditures are based on people's behavior with the tax expenditures in place, the estimates do not reflect the amount of revenue that would be raised if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response to those changes.

tax credits to subsidize premiums for health insurance provided through new exchanges to be established under the Affordable Care Act will represent a new tax expenditure beginning in 2014, estimated to equal 0.4 percent of GDP over the 2014–2023 period.²

How Are Tax Expenditures Distributed Among Households?

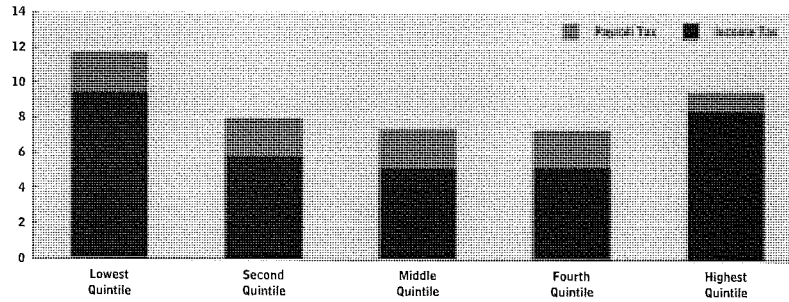
The 10 major tax expenditures considered here are distributed unevenly across the income scale. In calendar year 2013, more than half of the combined benefits of those tax expenditures will accrue to households with income in the highest quintile (or one-fifth) of the population (with 17 percent going to households in the top 1 percent of the population), CBO estimates. In contrast, 13 percent of those tax expenditures will accrue to households in the middle quintile, and only 8 percent

will accrue to households in the lowest quintile (see Summary Figure 1).

2. The Affordable Care Act comprises the Patient Protection and Affordable Care Act (Public Law 111-148) and the health care provisions of the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) and, in the case of this document, the effects of subsequent related judicial decisions, statutory changes, and administrative actions. For more information on CBO and JCT's projections of subsidies under the Affordable Care Act, see Congressional Budget Office, *Updated Budget Projections: Fiscal Years 2013 to 2023* (May 2013), www.cbo.gov/publication/44172, and "CBO's Estimate of the Net Budgetary Impact of the Affordable Care Act's Health Insurance Coverage Provisions Has Not Changed Much Over Time," *CBO Blog* (May 14, 2013), www.cbo.gov/publication/44176. The tax expenditure that will arise from premium assistance credits will represent only part of the total subsidies to be provided through exchanges; subsidies of cost-sharing expenses for health insurance, which are not included in this analysis, will represent the other major part.

Summary Figure 2.**Selected Major Tax Expenditures as a Share of Income, by Income Group, 2013**

(Percentage of after-tax income)



Source: Congressional Budget Office.

Notes: Quintiles, or fifths, are created by ranking households by their before-tax income. Quintiles contain equal numbers of people.

The selected major tax expenditures are the exclusion of employers' contributions for health care, health insurance premiums, and long-term care insurance premiums; the exclusion of net pension contributions and earnings; the exclusion of capital gains on assets transferred at death; the exclusion of a portion of Social Security and Railroad Retirement benefits; the deduction for mortgage interest on owner-occupied residences; the deduction of nonbusiness state and local government income, sales, real estate, and personal property taxes; the deduction for charitable contributions; reduced rates on dividends and long-term capital gains; the earned income tax credit; and the child tax credit.

The expenditures for the exclusion of employers' contributions for health care, health insurance premiums, and long-term care insurance premiums and for the exclusion of net pension contributions and earnings include the effect on payroll taxes. The expenditures for the earned income tax credit and the child tax credit include the effect on outlays.

Because estimates of tax expenditures are based on people's behavior with the tax expenditures in place, the estimates do not reflect the amount of revenue that would be raised if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response to those changes.

When measured relative to after-tax income, those 10 major tax expenditures are largest for the lowest and highest income quintiles. In calendar year 2013, CBO estimates, the combined benefits will equal nearly 12 percent of after-tax income for households in the lowest income quintile, more than 9 percent for households in the highest quintile, and less than 8 percent for households in the middle three quintiles (see Summary Figure 2).

The distribution of tax expenditures across the income scale varies considerably among the different tax expenditures. For example, CBO estimates that more than 90 percent of the benefits of reduced tax rates on capital gains and dividends will accrue to households in the highest income quintile in 2013, with almost 70 percent going to households in the top percentile. Those benefits will equal 2 percent of after-tax income for the highest

quintile and 5 percent of after-tax income for households in the top percentile. In contrast, about half of the benefits of the earned income tax credit will accrue to households in the lowest income quintile, equaling 6 percent of after-tax income for households in that group.

Tax credits that will provide assistance in paying premiums in health insurance exchanges are excluded from the distributional results presented here because they are not in effect in 2013. When those tax credits come into effect, they will appreciably increase tax expenditures for households in the lower and middle income quintiles. Individuals and families who have income between 100 percent and 400 percent of the federal poverty guidelines and who meet certain other requirements will be eligible for those credits.

How Do Tax Expenditure Estimates Differ From Revenue Estimates?

Estimates of tax expenditures are traditionally intended to measure the difference between households' tax liabilities under present law and the tax liabilities they would have incurred if the provisions generating those tax expenditures were repealed but households' behavior was unchanged. Such estimates do not represent the amount of revenues that would be raised if those provisions were eliminated, because the changes in incentives that would result from eliminating those provisions would lead households to modify their behavior in ways that would mute the impact on revenues. For example, if the preferential tax rates on capital gains realizations were eliminated, taxpayers would reduce the amount of capital gains they realized. Because the size of that tax expenditure is estimated on the basis of the gains that are projected to be realized with the preferential rates in place, the amount of additional revenues that would be received if those preferences were eliminated would be smaller than the reported tax expenditure.

An Overview of Tax Expenditures

Tax expenditures are "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability," according to the Congressional Budget and Impoundment Control Act of 1974.³ That law requires that a list of tax expenditures be included in the federal budget.³ The Administration and the Congress publish estimates of individual and corporate income tax expenditures, prepared by the Department of the Treasury's Office of Tax Analysis and the staff of the Congress's Joint Committee on Taxation (JCT), respectively.⁴

Tax expenditures have a significant impact on the federal budget and address a wide range of policy goals. They are similar in many respects to spending programs, although their budgetary treatment differs. Estimates of tax expenditures have some distinctive characteristics that are important to consider when interpreting those estimates.

Impact on the Federal Budget

On the basis of estimates prepared by JCT, the Congressional Budget Office projects that the 10 major

tax expenditures in the individual income tax code considered in this report will total nearly \$12 trillion—or 5.4 percent of gross domestic product—during fiscal years 2014 through 2023.⁵ The 10 tax expenditures examined in this report are the ones with the largest effects on individual income taxes in fiscal year 2013, according to JCT's estimates—except for the exclusion from taxable income of Medicare benefits, as discussed below. In addition, tax credits that will provide assistance in paying premiums in health insurance exchanges, which are not in effect in 2013, are estimated to equal 0.5 percent of GDP over the 2014–2023 period.

CBO's projection incorporates interactions among the provisions of law that generate the tax expenditures, and it includes the effects on both income taxes and payroll taxes. The effect on payroll taxes arises because some of the provisions of law that reduce the amount of taxable income under the income tax also decrease the amount of earnings subject to payroll taxes. (Provisions that reduce payroll tax receipts generally reduce future spending for Social Security benefits because those benefits are based on earnings subject to Social Security taxes; that effect on future government spending is not analyzed in this report.) In fiscal year 2013, those 10 major tax expenditures, taken together, will equal about one-third of total federal revenues and will exceed spending on Social Security, defense, or Medicare net of beneficiaries'.

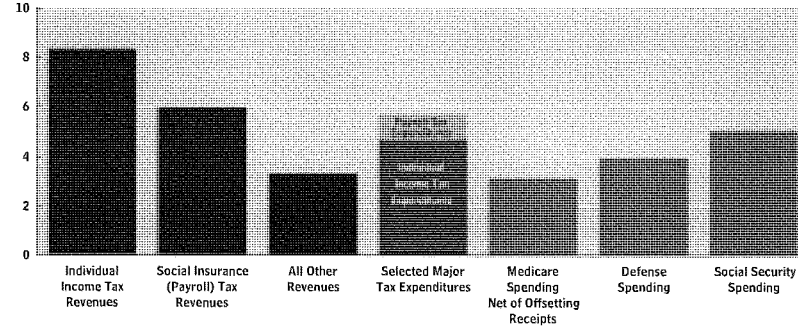
4. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017*, JCS-1-13 (February 1, 2013), www.jct.gov/publications.html?func=fileinfo&id=4503; and Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2013: Analytical Perspectives* (February 2012), Chapter 17, www.gpo.gov/fdsys/search/pagedetails.action?granuleId=&packageId=BUDGET-2013-PER. For additional background on tax expenditures, see Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 112-45 (prepared by the Congressional Research Service, December 2012), www.gpo.gov/fdsys/pkg/CPRT-112SPRT77698/pdf/CPRT112SPRT77698.pdf (53 MB).

5. CBO extrapolated JCT's estimates for the 2012–2017 period through 2023. JCT defines tax expenditures as deviations from an individual income tax structure that incorporates the existing regular tax rates, standard deduction, personal exemptions, and deduction of business expenses. CBO combined the components of certain tax expenditures that JCT reports separately, such as tax expenditures for different types of charitable deductions and for different types of net pension contributions and earnings. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017*, JCS-1-13 (February 1, 2013), www.jct.gov/publications.html?func=fileinfo&id=4503.

3. Sec. 3(3) of the Congressional Budget and Impoundment Control Act of 1974, P.L. 93-344 (codified at 2 U.S.C. §622(3) (2006)).

Figure 1.**Selected Components of Revenues, Major Tax Expenditures, and Spending, Fiscal Year 2013**

(Percentage of gross domestic product)



Sources: Congressional Budget Office; staff of the Joint Committee on Taxation.

Notes: The selected major tax expenditures are the exclusion of employers' contributions for health care, health insurance premiums, and long-term care insurance premiums; the exclusion of net pension contributions and earnings; the exclusion of capital gains on assets transferred at death; the exclusion of a portion of Social Security and Railroad Retirement benefits; the deduction for mortgage interest on owner-occupied residences; the deduction of nonbusiness state and local government income, sales, real estate, and personal property taxes; the deduction for charitable contributions; reduced rates on dividends and long-term capital gains; the earned income tax credit; and the child tax credit.

The expenditures for the exclusion of employers' contributions for health care, health insurance premiums, and long-term care insurance premiums and for the exclusion of net pension contributions and earnings include the effect on payroll taxes. The expenditures for the earned income tax credit and the child tax credit include the effect on outlays.

Because estimates of tax expenditures are based on people's behavior with the tax expenditures in place, the estimates do not reflect the amount of revenue that would be raised if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response to those changes.

premiums and other offsetting receipts, CBO estimates (see Figure 1).

The size of tax expenditures depends on many features of tax law and on economic conditions. Since the Tax Reform Act of 1986 reduced or eliminated many tax expenditures, total individual and corporate income tax expenditures (not including forgone payroll taxes) have risen, on balance, from less than 6 percent of GDP to more than 7 percent of GDP. In addition, the composition of tax expenditures has changed significantly over time.⁶ For example, tax legislation has introduced and expanded the child tax credit, expanded the earned income tax credit, lowered and also raised the preferential tax rate for long-term capital gains (the profit when an investment held for more than one year is sold), and

introduced a preferential tax rate for dividends. Also since 1986, the tax expenditure for the exclusion from taxable income of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums (hereafter described as the exclusion for employer-sponsored health insurance, or ESI) has grown by more than two-thirds as a share of GDP, primarily because of rapid growth in health care spending. Tax expenditures associated with the preferential rate on

6. For details on the history of tax expenditures, see Joint Committee on Taxation, *Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates*, JCS-15-11 (February 28, 2011), www.jct.gov/publications.html?func=6leinfo&id=3740; and Thomas L. Hungerford, *Tax Expenditures and the Federal Budget*, Report for Congress RL34622 (Congressional Research Service, June 1, 2011).

Table 1.**Budgetary Effects of Selected Major Tax Expenditures, Fiscal Years 2013 to 2023**

	2013		2014 to 2023	
	Billions of Dollars	Percentage of GDP	Billions of Dollars	Percentage of GDP
Exclusions from Taxable Income				
Employer-sponsored health insurance ^a	248	1.5	3,360	1.6
Net pension contributions and earnings ^a	137	0.9	1,999	0.9
Capital gains on assets transferred at death	43	0.3	644	0.3
A portion of Social Security and Railroad Retirement benefits	33	0.2	414	0.2
Deductions				
State and local taxes	77	0.5	1,098	0.5
Mortgage interest	70	0.4	1,011	0.5
Charitable contributions	39	0.2	568	0.3
Preferential Tax Rates on Capital Gains and Dividends	161	1.0	1,340	0.6
Credits				
Earned income tax credit ^b	61	0.4	661	0.3
Child tax credit ^b	57	0.4	549	0.3
Memorandum:				
Credits for Premiums in Health Insurance Exchanges ^b	0	0	920	0.4

Sources: Congressional Budget Office; staff of the Joint Committee on Taxation.

Notes: Because estimates of tax expenditures are based on people's behavior with the tax expenditures in place, the estimates do not reflect the amount of revenue that would be raised if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response to those changes.

The exclusion from taxable income of employer-sponsored health insurance includes employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums.

GDP = gross domestic product.

a. Includes effect on payroll taxes.

b. Includes effect on outlays.

capital gains and the exclusion of unrealized capital gains on assets transferred at death are particularly volatile, rising and falling over time with the prices of stocks and other assets.

The exclusion for employer-sponsored health insurance is the single largest tax expenditure in the individual income tax code. Including the forgone payroll taxes, that expenditure is projected to equal 1.5 percent of GDP in fiscal year 2013 and 1.6 percent of GDP between 2014 and 2023 (see Table 1). The exclusion of net pension contributions and earnings is the second-largest tax expenditure over the next decade, equaling 0.9 percent of GDP in fiscal year 2013 and during the 2014–2023 period. The tax expenditure arising from preferential tax rates on dividends and long-term capital gains is expected to total 1.0 percent of GDP in fiscal year 2013 and about

0.6 percent of GDP over the ensuing decade; the deduction for taxes paid to state and local governments is expected to equal 0.5 percent of GDP both in fiscal year 2013 and in the following decade; and the deduction for interest paid on mortgages for owner-occupied residences is estimated to equal 0.4 percent of GDP in fiscal year 2013 and 0.5 percent of GDP over the next decade.⁷ The other five tax expenditures examined here are each

7. CBO and JCT estimate that a significant amount of capital gains realizations and dividend payouts were accelerated into calendar year 2012 in anticipation of the tax rate increases that were scheduled to take effect in 2013. Because the taxes owed on those capital gains will probably be paid mostly in calendar year 2013, that shifting boosts the estimated amount of the fiscal year 2013 tax expenditure.

projected to equal between 0.2 percent and 0.4 percent of GDP in fiscal year 2013 and during the 2014–2023 period.

One tax expenditure that is not examined in this report is the exclusion from taxable income of Medicare benefits. JCT considers the exclusion of benefits under Medicare Part A that are in excess of the Part A payroll taxes paid by beneficiaries during their working years to be a tax expenditure, which is estimated to equal 0.2 percent of GDP in fiscal year 2013.⁸ JCT also considers the exclusion of benefits under Medicare Part B in excess of the premiums paid by beneficiaries to be a tax expenditure, also equal to 0.2 percent of GDP in fiscal year 2013, and the exclusion of benefits under Medicare Part D to be a tax expenditure, equal to less than 0.1 percent of GDP.⁹ CBO's distributional analysis omitted the exclusion of Medicare benefits: Analysis of the distribution of that exclusion would be quite uncertain, as the distribution depends critically on the lifetime Medicare payroll taxes paid by beneficiaries (about which CBO does not have adequate data) and on how Medicare benefits are distributed among individual households (for which estimates based on actual health care expenditures, for example, would differ substantially from estimates based on amounts of health insurance premiums).

Other, smaller health-related tax expenditures (such as the itemized deduction for medical expenses, the tax-favored treatment of health savings accounts, and the health insurance deduction for self-employed workers) are also excluded from this analysis. Including the ESI and Medicare exclusions, total health-related tax expenditures are estimated to equal 2.2 percent of GDP in fiscal year 2013. That amount rivals federal outlays for the two biggest health care programs, Medicare (for which spending net of beneficiaries' premiums and other offsetting receipts equals 3.1 percent of GDP) and Medicaid (for which federal spending is 1.7 percent of GDP).

8. In contrast with JCT's approach, the Department of the Treasury does not list the exclusion of Medicare benefits as a tax expenditure. Only untaxed cash transfer payments from the government are considered tax expenditures by the Treasury.

9. Part A of Medicare covers hospitalization; Part B covers doctors' services, outpatient care, home health services, and other medical services; and Part D covers outpatient prescription drugs. Part C specifies the rules under which private health care plans can assume responsibility for, and be compensated for, providing benefits under Parts A, B, and D.

Tax credits that will provide assistance in paying premiums in new health insurance exchanges to be established under the Affordable Care Act will represent a new tax expenditure beginning in 2014. CBO and JCT estimate that those tax credits will equal 0.2 percent of GDP in 2015 and grow to 0.5 percent of GDP by 2023. The Affordable Care Act also put in place a new excise tax on health insurance plans with relatively high premiums, which is scheduled to take effect in 2018. CBO and JCT expect that tax to restrain spending on employer-sponsored health insurance, which will reduce the ESI tax expenditure relative to what would otherwise have occurred.

Policy Goals

The provisions of law that lead to tax expenditures are generally designed to further societal goals. For example, the tax expenditures for health insurance costs, pension contributions, and mortgage interest payments may help to promote a healthier population, adequate financial resources for retirement and greater national saving, and stable communities of homeowners. However, tax expenditures have a broad range of effects that do not always further societal goals.

First, tax expenditures may lead to an inefficient allocation of economic resources by encouraging more consumption of goods and services receiving preferential treatment; they also may subsidize activity that would have taken place without the tax incentives. For example, the tax expenditures mentioned above may prompt people to be less cost-conscious in their use of health care services than they would be in the absence of the tax expenditure for health insurance costs; to reallocate existing savings from accounts that are not tax-preferred to retirement accounts, rather than add to their savings; and to purchase more expensive homes, investing too much in housing and too little elsewhere relative to what they would do if all investments were treated equally.

Second, by providing benefits to specific activities, entities, or groups of people, tax expenditures increase the size and scope of federal involvement in the economy. Indeed, adding tax expenditures to conventional federal outlays makes the federal government appear notably larger relative to GDP.¹⁰

10. For more details, see Donald Marron and Eric Toder, *How Big Is the Federal Government?* (Urban-Brookings Tax Policy Center, March 26, 2012), www.taxpolicycenter.org/publications/url.cfm?ID=412528.

Third, tax expenditures reduce the amount of revenue that is collected for any given set of statutory tax rates—and thereby require higher rates to collect any chosen amount of revenue. All else being equal, those higher tax rates lessen people's incentives to work and save and therefore decrease output and income. At the same time, some tax expenditures more directly affect output and income. For example, the preferential rate on capital gains and dividends raises the after-tax return on some forms of saving, which tends to increase saving and boost future output. As another example, the increase in take-home pay arising from the earned income tax credit appears to encourage work effort by some people.

Fourth, tax expenditures have mixed effects on the societal goal of limiting the complexity of the tax code. On the one hand, most tax expenditures, such as itemized deductions and tax credits, require that taxpayers keep additional records and make additional calculations, increasing the complexity of the tax code. On the other hand, some exclusions from taxable income simplify the tax code by eliminating recordkeeping requirements and the need for certain calculations. For example, in the absence of the exclusion for capital gains on assets transferred at death, taxpayers would need to calculate the appreciation in the value of their assets since the original purchase—a calculation that would require records of the purchase of assets acquired by deceased benefactors, perhaps many decades earlier.

Fifth, tax expenditures affect the distribution of the tax burden in ways that may not always be recognized, both among people at different income levels and among people who have similar income but differ in other ways. This report analyzes those distributional effects.

Comparison With Spending Programs

Both tax expenditures and spending programs provide financial assistance for particular activities, entities, or groups of people. Through that assistance, tax expenditures and spending programs alter people's behavior, change the allocation of resources in the economy, and transfer income among households. Indeed, many tax expenditures could instead be implemented as government spending programs that would have economic effects similar to those of the tax expenditures. However, the budgetary treatment and administration of such spending programs would be quite different from those of the tax expenditures.

From a budgetary perspective, tax expenditures are more like mandatory spending (spending for programs that is generally determined by setting eligibility rules and benefit formulas) than like discretionary spending (which is governed by the annual appropriation process). In particular, tax expenditures generally are not subject to appropriations, and any person or entity that meets the requirements for them can receive the benefits.¹¹ Unlike mandatory spending, however, tax expenditures usually are not recorded separately in the federal budget: Although tax expenditures reduce the amount of revenue received by the government and recorded in the budget, the amount of forgone revenue that is attributable to specific tax expenditures or to all tax expenditures is not recorded. The exception to that approach involves the refundable portion of tax credits, which is treated in the budget as a government outlay. Because of the budgetary treatment of tax expenditures, their costs are much less transparent than the costs of spending programs.

From an administrative perspective, tax expenditures arise through the operation of the tax code and are generally administered by the Internal Revenue Service (IRS); in contrast, most spending programs are administered by specialized agencies with expertise in the relevant programs and issues. On the one hand, that distinction reduces the cost of administering a tax expenditure compared with an analogous spending program. For a tax expenditure, no new administrative structure needs to be created, and the detailed financial information that the IRS already collects about taxpayers offers the potential for improved oversight and targeting of the expenditure. On the other hand, the IRS may lack the resources, knowledge, and institutional focus to manage activities that are unrelated to the agency's primary mission of revenue collection.

Key Features of CBO's Estimates

To conduct the analysis in this report, CBO estimated the magnitude of each tax expenditure for each household as the difference between the household's tax liability under present law and the tax liability it would have if the provisions generating that tax expenditure were repealed but the household's behavior was unchanged.

11. However, some smaller tax expenditures, such as the low-income housing tax credit and certain energy tax credits enacted in 2009, have budget ceilings and procedures to allocate the budgeted amount among taxpayers who apply for the credits.

Five features of those estimates bear emphasis (more details on CBO's estimation approach are discussed in the appendix).

First, those estimates of tax expenditures are not estimates of the additional revenues that would be raised if the relevant provisions of law were eliminated, because the estimates do not account for the way taxpayers would change their behavior as a result. For example, if the preferential tax rates on capital gains realizations were eliminated, taxpayers would reduce the amount of capital gains they realized. Because the size of that tax expenditure is estimated on the basis of the gains that are projected to be realized with the preferential rates in place, the amount of additional revenues that would be received if that preference was eliminated would be smaller than the estimated size of the tax expenditure.

Second, those estimates allocate the expenditures to the taxpayers who benefit directly from them, even though those expenditures may affect other people as well. For example, CBO's estimates of the distribution of the tax expenditure for the deduction of mortgage interest leave aside any effect of that expenditure on the amount of mortgage debt or on housing values.

Third, the estimated magnitude of a collection of tax expenditures may differ from the sum of the estimated magnitudes of the separate expenditures because of the interactions that arise among expenditures.

Fourth, this analysis differs from most other analyses of tax expenditures by including forgone payroll taxes in addition to forgone individual income taxes in both the aggregate amount and the distribution of tax expenditures. CBO chose to include the effects on payroll taxes because those effects follow naturally from the provisions of law that create tax expenditures in the individual income tax. If, instead, the analysis excluded the forgone payroll taxes, the distribution of tax expenditures would be somewhat less progressive (or more skewed toward higher-income households) than is reported here.

Finally, tax expenditures are measured relative to a comprehensive income tax system. If tax expenditures were evaluated relative to an alternative tax system—for instance, a comprehensive consumption tax, such as a national retail sales tax or a value-added tax—some of the 10 major tax expenditures analyzed here would not be considered tax expenditures. For example, because a consumption tax would exclude all savings and investment

income from taxation, the exclusion of net pension contributions and earnings would be considered part of the normal tax system and not a tax expenditure.

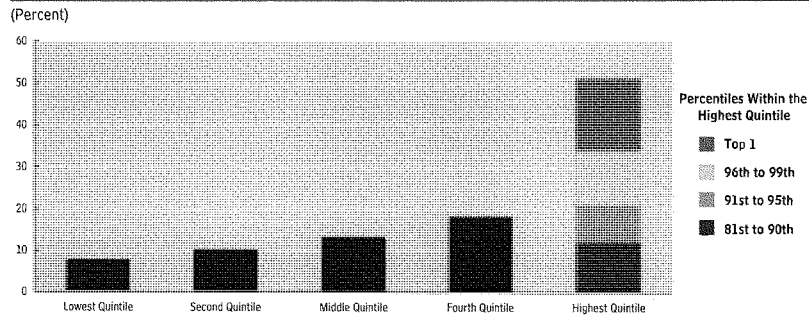
The Distribution of a Set of Selected Tax Expenditures

Tax expenditures are distributed unevenly across the income scale. When measured in dollars, tax expenditures benefit higher-income households much more than lower-income households. When measured relative to income, tax expenditures benefit households in the lowest and highest income groups to a greater extent than households in the middle of the income distribution.¹² If payroll tax effects were excluded from these estimates, the distribution of tax expenditures would appear somewhat less progressive than what is shown here but not fundamentally different.

Distribution in Dollars

Higher-income households benefit significantly more from tax expenditures in dollar terms than do lower-income households. For 2013, CBO estimates that 51 percent of the total benefits from the 10 major tax expenditures analyzed in this report will accrue to households that make up the one-fifth of people with the highest before-tax income, 13 percent will accrue to households in the middle quintile, and 8 percent will accrue to households in the bottom quintile (see Figure 2).

12. Various analysts have assessed the distributional effects of tax expenditures. JCT regularly includes estimates of the distribution of selected tax expenditures in its annual estimates of aggregate expenditures. In addition, several nongovernmental researchers have analyzed the distribution of selected tax expenditures and of tax expenditures as a whole. See, for example, Eric Toder and Daniel Baneman, *Distributional Effects of Individual Income Tax Expenditures: An Update* (Urban-Brookings Tax Policy Center, February 2, 2012), www.taxpolicycenter.org/publications?url.cfm?ID=412495; Hang Nguyen and others, *How Hard Is It to Cut Tax Preferences to Pay for Lower Tax Rates?* (Urban-Brookings Tax Policy Center, July 10, 2012), www.taxpolicycenter.org/publications?url.cfm?ID=412608; James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review*, vol. 98, no. 2 (May 2008), pp. 84–89, <http://dx.doi.org/10.1257/aer.98.2.84>; and Joseph J. Cordes, "Re-Thinking the Deduction for Charitable Contributions: Evaluating the Effects of Deficit-Reduction Proposals," *National Tax Journal*, vol. 64, no. 4 (December 2011), pp. 1001–1024, <http://ntj.tax.org>.

Figure 2.**Shares of Selected Major Tax Expenditures, by Income Group, 2013**

Source: Congressional Budget Office.

Notes: Quintiles, or fifths, are created by ranking households by their before-tax income. Quintiles contain equal numbers of people.

The selected major tax expenditures are the exclusion of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums; the exclusion of net pension contributions and earnings; the exclusion of capital gains on assets transferred at death; the exclusion of a portion of Social Security and Railroad Retirement benefits; the deduction for mortgage interest on owner-occupied residences; the deduction of nonbusiness state and local government income, sales, real estate, and personal property taxes; the deduction for charitable contributions; reduced rates on dividends and long-term capital gains; the earned income tax credit; and the child tax credit.

The expenditures for the exclusion of employers' contributions for health care, health insurance premiums, and long-term care insurance premiums and for the exclusion of net pension contributions and earnings include the effect on payroll taxes. The expenditures for the earned income tax credit and the child tax credit include the effect on outlays.

Because estimates of tax expenditures are based on people's behavior with the tax expenditures in place, the estimates do not reflect the amount of revenue that would be raised if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response to those changes.

Distribution as a Share of Income

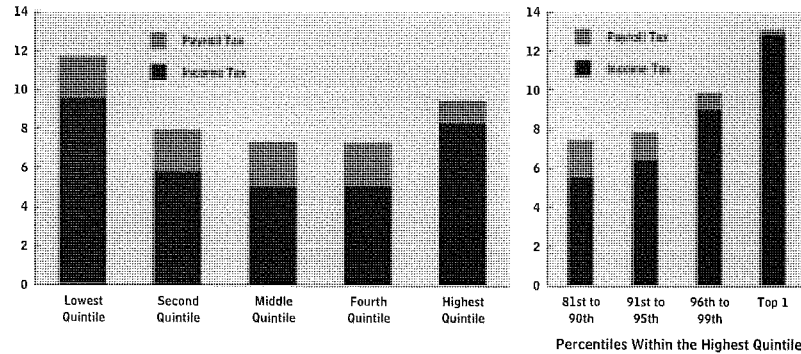
Household income is also unevenly distributed, even after accounting for the progressive effects of transfers and federal taxes.¹³ When tax expenditures are measured as a share of after-tax, after-transfer income (hereafter

called "after-tax income"), they benefit households in the lowest and highest income groups by more than households in the middle of the income distribution. For 2013, CBO estimates that the 10 tax expenditures analyzed in this report will equal 11.7 percent of after-tax income for households in the bottom quintile, 9.4 percent of after-tax income for households in the highest quintile, and between 7 percent and 8 percent of after-tax income for households in the middle three quintiles (see Figure 3). Within the top quintile, tax expenditures rise as a share of after-tax income. For 2013, CBO estimates, tax expenditures will be 7.4 percent of income for households in the 81st to 90th percentiles (a similar rate to that of the middle three quintiles), 9.9 percent of income for households in the 96th to 99th percentiles, and 13.1 percent of income for households in the top percentile.

13. CBO estimates that in 2009, the last year for which the agency estimated the distribution of income and taxes, households in the lowest income quintile received 5 percent of before-tax income, households in the middle quintile received 15 percent, and households in the highest quintile received 51 percent. Because average federal tax rates rise with income, however, after-tax, after-transfer income is more evenly distributed than before-tax income. In 2009, households in the lowest income quintile received 6 percent of after-tax income, households in the middle quintile received 16 percent, and households in the highest quintile received 47 percent. See Congressional Budget Office, *The Distribution of Household Income and Federal Taxes, 2008 and 2009* (July 2012), www.cbo.gov/publication/43373.

Figure 3.**Selected Major Tax Expenditures as a Share of Income, by Income Group and Subgroups, 2013**

(Percentage of after-tax income)



Source: Congressional Budget Office.

Notes: Income categories are created by ranking all households by their before-tax income. Percentiles (hundredths) and quintiles (fifths) contain equal numbers of people.

The selected major tax expenditures are the exclusion of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums; the exclusion of net pension contributions and earnings; the exclusion of capital gains on assets transferred at death; the exclusion of a portion of Social Security and Railroad Retirement benefits; the deduction for mortgage interest on owner-occupied residences; the deduction of nonbusiness state and local government income, sales, real estate, and personal property taxes; the deduction for charitable contributions; reduced rates on dividends and long-term capital gains; the earned income tax credit; and the child tax credit.

The expenditures for the exclusion of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums and for the exclusion of net pension contributions and earnings include the effect on payroll taxes. The expenditures for the earned income tax credit and the child tax credit include the effect on outlays.

Because estimates of tax expenditures are based on people's behavior with the tax expenditures in place, the estimates do not reflect the amount of revenue that would be raised if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response to those changes.

Distribution Excluding Payroll Taxes

The forgone payroll tax revenues from tax expenditures are roughly flat as a share of after-tax income in the bottom four quintiles of the income distribution, but they are a smaller share of income in the highest quintile and a much smaller share in the top 5 percent of the income distribution. Thus, the benefits of tax expenditures rise more sharply with income when only income taxes—rather than both income and payroll taxes—are considered. Still, tax expenditures from the individual income tax alone provide the greatest benefit as a share of after-tax income to households in the lowest and highest

income quintiles, consistent with the results reported here for tax expenditures from income and payroll taxes together.

The Distribution of Selected Individual Tax Expenditures

The overall distribution of tax expenditures masks significant variation in the distribution of various categories of those expenditures (see Figure 4).

- **Exclusions.** The benefits of exclusions from taxable income are roughly evenly distributed among

quintiles, ranging from 4.2 percent to 5.2 percent of after-tax income in 2013, according to CBO's estimates; the middle and fourth quintiles will receive slightly larger benefits than households at either end of the distribution.

- **Deductions.** The benefits of itemized deductions rise sharply with income in 2013, ranging from less than 0.1 percent of after-tax income for households in the lowest quintile to 0.4 percent for households in the middle quintile to 2.5 percent for households in the highest income quintile, CBO estimates.
- **Preferential Tax Rates.** The preferential tax rates on dividends and capital gains provide almost no benefits to households in the bottom four quintiles but provide notable benefits to households in the top quintile—amounting to 1.7 percent of after-tax income in 2013, according to CBO's estimates.
- **Tax Credits.** The largest tax credits are distributed very differently than the other categories of tax expenditures. The credits provide very large benefits to households in the lowest income quintile (8.1 percent of after-tax income in 2013, by CBO's estimate) and decreasing benefits to households in higher quintiles (amounting to 1.5 percent of income in the middle quintile and just 0.1 percent in the highest quintile).

Relative to income, deductions and preferential rates generally provide larger benefits to higher-income taxpayers than to other taxpayers, whereas tax credits generally provide bigger benefits to lower-income households. Exclusions from taxable income tend to be distributed roughly evenly across most income groups.

Exclusions

Of the 10 major tax expenditures that CBO examined, four are exclusions of certain types of income from taxation:

- Employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums for their employees;
- Contributions to and earnings of pension funds (minus pension benefits included in taxable income);
- Capital gains from assets transferred at death; and

- A portion of Social Security and Railroad Retirement benefits.

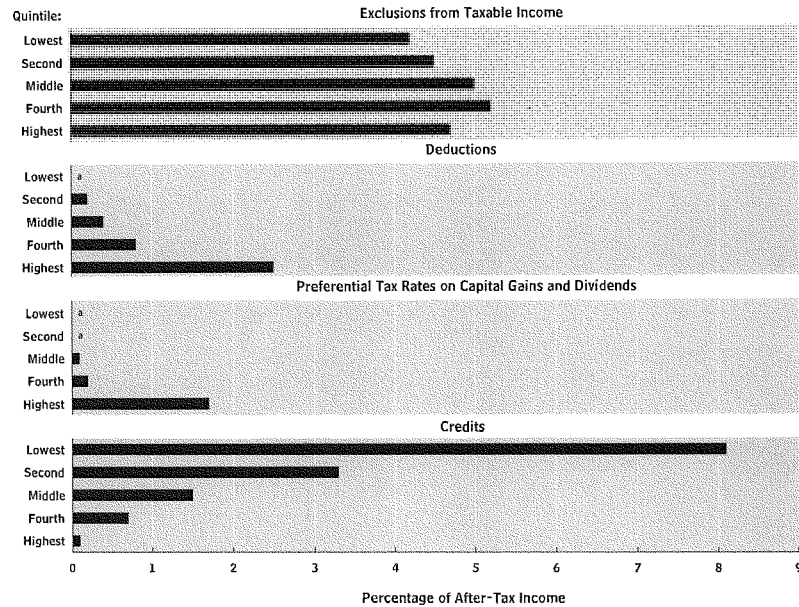
CBO estimates that those four exclusions, taken together, will reduce tax liabilities by roughly \$480 billion, or about 4.9 percent of total after-tax income, in 2013.

Because the exclusions for employer-sponsored health insurance and pension contributions also reduce the base for payroll taxes, CBO calculated the effects of those provisions on both payroll taxes and individual income taxes. That approach differs from the way in which JCT and the Treasury estimate tax expenditures; estimates from those agencies generally include only the effects on income taxes. Not counting the effects on payroll taxes, CBO estimates that the four exclusions considered here will reduce tax liabilities by more than \$300 billion, or about 3.2 percent of after-tax income, in 2013.

Payroll taxes are a much flatter share of income across the income distribution than income taxes are, so excluding payroll taxes would make the distribution of those tax expenditures more tilted toward the top of the income scale. This report considers only the tax effects of the selected tax expenditures that affect payroll taxes. However, provisions that reduce the payroll tax base also reduce future Social Security benefits. Because those future benefits tend to be distributed more progressively than current payroll taxes (benefits are a larger percentage of lifetime earnings for workers with lower lifetime earnings), an analysis that incorporated those exclusions' effects on future Social Security benefits as well as on payroll and income taxes would probably show net benefits to be more skewed toward higher-income taxpayers than this analysis, which considers only the effects on taxes.

Employer-Sponsored Health Insurance. The exclusion of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums for their employees is the single largest tax expenditure in the individual income tax code; it is estimated to reduce tax liabilities by \$260 billion (or \$140 billion excluding the effects on payroll taxes) in 2013 (see Figure 5).¹⁴ CBO estimates that 34 percent of that expenditure will accrue

14. CBO's estimate of the individual income tax portion of the total tax expenditure for calendar year 2013 is consistent with the estimate of that figure from JCT for fiscal years 2013 and 2014.

Figure 4.**Selected Major Tax Expenditures as a Share of Income, by
Income Group and Type of Expenditure, 2013**

Source: Congressional Budget Office.

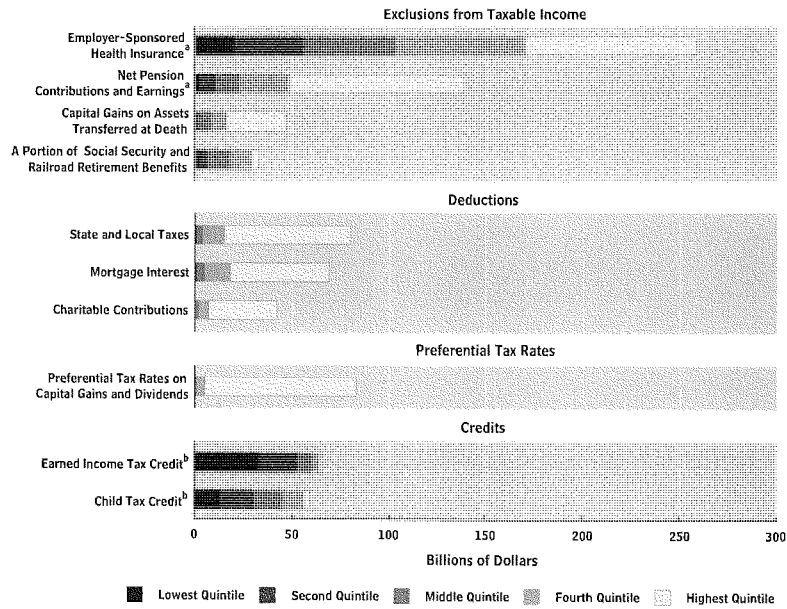
Notes: Quintiles, or fifths, are created by ranking households by their before-tax income. Quintiles contain equal numbers of people.

The selected major tax expenditures are the exclusion of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums; the exclusion of net pension contributions and earnings; the exclusion of capital gains on assets transferred at death; the exclusion of a portion of Social Security and Railroad Retirement benefits; the deduction for mortgage interest on owner-occupied residences; the deduction of nonbusiness state and local government income, sales, real estate, and personal property taxes; the deduction for charitable contributions; reduced rates on dividends and long-term capital gains; the earned income tax credit; and the child tax credit.

The expenditures for the exclusion of employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums and for the exclusion of net pension contributions and earnings include the effect on payroll taxes. The expenditures for the earned income tax credit and the child tax credit include the effect on outlays.

Because estimates of tax expenditures are based on people's behavior with the tax expenditures in place, the estimates do not reflect the amount of revenue that would be raised if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response to those changes.

a. Between zero and 0.05 percent.

Figure 5.**Size and Distribution of Selected Major Tax Expenditures, by Income Group, 2013**

Source: Congressional Budget Office.

Notes: Quintiles, or fifths, are created by ranking households by their before-tax income. Quintiles contain equal numbers of people.

Because estimates of tax expenditures are based on people's behavior with the tax expenditures in place, the estimates do not reflect the amount of revenue that would be raised if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response to those changes.

The exclusion from taxable income of employer-sponsored health insurance includes employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums.

a. Includes effect on payroll taxes.

b. Includes effect on outlays.

to the top quintile of the income distribution, 26 percent to the fourth quintile, 19 percent to the middle quintile, and 22 percent to the bottom two quintiles combined (see Table 2). Measured as a share of after-tax income, the ESI exclusion is fairly flat across the bottom four quintiles, ranging from 3.1 percent to 3.5 percent of income.

Taxpayers in the highest quintile will receive smaller benefits relative to income, equal to 1.9 percent of income, and those in the top percentile will receive benefits equal to only 0.5 percent of income. (Excluding the effects on payroll taxes, CBO estimates that the exclusion is less progressive, with benefits of 1.3 percent to 1.4 percent of

Table 2.**Distribution of Selected Major Tax Expenditures, by Income Group, 2013**

(Percent)

Tax Expenditure	Percentiles Within the Highest Quintile									
	Lowest Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Highest Quintile	All Quintiles	81st-90th	91st-95th	96th-99th	Top 1%
	Share of Each Tax Expenditure									
Exclusions from Taxable Income										
Employer-sponsored health insurance ^a	8	14	19	26	34	100	16	9	8	2
Net pension contributions and earnings ^a	2	5	9	18	66	100	17	13	22	14
Capital gains on assets transferred at death	*	3	15	17	65	100	10	6	28	21
A portion of Social Security and Railroad Retirement benefits	3	15	36	33	13	100	8	3	2	1
All Exclusions (Including interactions)	5	10	16	23	45	100	15	9	14	7
Deductions										
State and local taxes	*	1	4	14	80	100	17	15	19	30
Mortgage interest	*	2	6	18	73	100	19	16	23	15
Charitable contributions	*	1	4	11	84	100	13	12	21	38
All Deductions (Including interactions)	*	1	4	13	81	100	15	14	22	30
Preferential Tax Rates on Capital Gains and Dividends	*	*	2	5	93	100	5	5	14	68
Credits										
Earned income tax credit ^b	51	29	12	6	3	100	2	*	*	*
Child tax credit ^b	22	29	26	18	4	100	3	1	*	*
All Credits (Including interactions)	37	29	19	12	3	100	3	1	*	*
All Expenditures (Including interactions)	8	10	13	18	51	100	12	9	13	17
Tax Expenditure as a Share of After-Tax Income										
Exclusions from Taxable Income										
Employer-sponsored health insurance ^a	3.5	3.2	3.1	3.1	1.9	2.6	2.8	2.4	1.7	0.5
Net pension contributions and earnings ^a	0.4	0.7	0.8	1.2	2.0	1.4	1.6	2.0	2.7	1.7
Capital gains on assets transferred at death	**	0.1	0.5	0.4	0.7	0.5	0.3	0.3	1.2	0.9
A portion of Social Security and Railroad Retirement benefits	0.2	0.5	0.8	0.5	0.1	0.3	0.2	0.1	0.1	**
All Exclusions (Including interactions)	4.2	4.5	5.0	5.2	4.7	4.9	5.0	4.8	5.7	3.2
Deductions										
State and local taxes	**	0.1	0.2	0.5	1.4	0.8	0.9	1.3	1.3	2.2
Mortgage interest	**	0.1	0.3	0.6	1.1	0.7	0.9	1.2	1.4	0.9
Charitable contributions	**	**	0.1	0.2	0.7	0.4	0.4	0.5	0.7	1.4
All Deductions (Including interactions)	**	0.2	0.4	0.8	2.5	1.4	1.5	2.1	2.7	3.9
Preferential Tax Rates on Capital Gains and Dividends	**	**	0.1	0.2	1.7	0.9	0.3	0.5	1.0	5.3
Credits										
Earned income tax credit ^b	5.8	1.7	0.5	0.2	**	0.7	0.1	**	**	**
Child tax credit ^b	2.3	1.5	0.9	0.5	0.1	0.6	0.1	**	**	**
All Credits (Including interactions)	8.1	3.3	1.5	0.7	0.1	1.3	0.2	0.1	**	**
All Expenditures (Including interactions)	11.7	7.9	7.3	7.3	9.4	8.7	7.4	7.8	9.9	13.1

Source: Congressional Budget Office.

Notes: Income categories are created by ranking all households by their before-tax income. Percentiles (hundredths) and quintiles (fifths) contain equal numbers of people. The exclusion from taxable income of employer-sponsored health insurance includes employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums.

* = between zero and 0.5 percent; ** = between zero and 0.05 percent.

a. Includes effect on payroll taxes.

b. Includes effect on outlays.

after-tax income for the bottom three quintiles, 1.6 percent for the fourth quintile, and 1.3 percent for the highest quintile.)

Several factors explain that distributional pattern. First, the likelihood of having employer-sponsored insurance increases with income. Because average health insurance premiums do not rise as much as income rises, however, the distribution of ESI premiums is less tilted than the distribution of income. Second, the combined income and payroll tax rate on employer-sponsored health insurance rises somewhat across the income distribution, and the tax savings from each dollar excluded increases along with the tax rate. Those factors combine to produce a distribution for the tax expenditure that is fairly flat relative to after-tax income across most of the income scale.

Net Pension Contributions and Earnings. The exclusion of net pension contributions and earnings is another of the largest tax expenditures, estimated to total roughly \$140 billion in 2013 (or \$90 billion excluding the effects on payroll taxes). The tax expenditure is defined as the difference between the current treatment of pension contributions and income and the treatment under a pure individual income tax in which contributions were made with after-tax income, investment earnings inside pension accounts were taxed like ordinary investment earnings, and pension distributions were tax-free. Compared with that hypothetical tax, the current tax expenditure can be thought of as having three distinct components. First, contributions to pension plans are excluded from taxation when they are made. (All contributions from employers are exempt from income and payroll taxes, and most contributions from employees are exempt from income tax.) Second, the investment earnings on balances held inside pension accounts—the largest component of the tax expenditure—are untaxed. Finally, pension benefits are taxed upon withdrawal; that component partially offsets the first two components. (For a discussion of an alternative approach to estimating this tax expenditure—under which the current and future taxes paid for retirement contributions made today are compared with the current and future taxes that would have been paid on an equivalent investment in a taxable account—see the appendix.)

The tax expenditure for the exclusion of net pension contributions and earnings tilts heavily toward the top of the income distribution, with the top quintile receiving two-thirds of the tax expenditure. CBO estimates that,

in 2013, households in the bottom quintile will receive benefits from this tax expenditure equal to 0.4 percent of after-tax income, households in the middle quintile will receive benefits equal to 0.8 percent of income, and households in the top quintile will receive benefits equal to 2.0 percent of income. Life-cycle earnings patterns explain some of that distribution, because households in their peak earnings years are most likely to have accumulated large balances in pension plans. Higher-income households also face higher marginal tax rates (the tax rate that would apply to an additional dollar of a taxpayer's income) and are more likely to be covered by pensions. In addition, the generosity of pension plans rises somewhat with income, although that effect is limited by caps on contributions and antidiscrimination rules, which prevent employers from making pension plans significantly more valuable for highly compensated employees than for other employees. (Not counting the effects on payroll taxes, the exclusion is less progressive, CBO estimates, with the bottom quintile receiving benefits equal to 0.2 percent of after-tax income; the middle quintile, 0.4 percent; and the top quintile, 1.5 percent. The highest-income households have a relatively smaller reduction in their benefit when payroll taxes are excluded because those households tend to pay a smaller share of their income in payroll taxes.)

Capital Gains on Assets Transferred at Death. The exclusion of capital gains on assets transferred at death is a smaller tax expenditure—estimated to be about \$50 billion in 2013—than the previous two exclusions. It also tilts toward the top of the income distribution: CBO estimates that 65 percent of the tax benefit accrues to the top quintile (with 21 percent going to the top 1 percent of households), and an additional 17 percent accrues to the fourth quintile. The exclusion of capital gains at death largely benefits households with high net worth, and such households tend to be in the upper portion of the income distribution.¹⁵

A Portion of Social Security and Railroad Retirement Benefits. The exclusion of a portion of Social Security and Railroad Retirement benefits generates a tax expenditure that is estimated to be about \$35 billion in 2013. The exclusion almost exclusively benefits middle-income taxpayers, CBO estimates, with 84 percent flowing to households in the middle three income quintiles. Higher-income taxpayers benefit little from the exclusion because they are required to include most of their Social Security benefits in their taxable income under current law.

Lower-income households also benefit little from the exclusion because the personal exemption and standard deduction already exclude from taxation a large portion of those benefits.

Deductions

Three of the 10 major tax expenditures that CBO examined allow people who itemize deductions to subtract from their taxable income their spending for certain items:

- State and local taxes (on income, sales, real estate, and personal property),
- Mortgage interest on owner-occupied residences, and
- Charitable contributions.

CBO estimates that those deductions, taken together and including interactions among them, will reduce tax liabilities by roughly \$140 billion in 2013. Eliminating those deductions would raise federal revenues by significantly less than that tax expenditure because people would modify their behavior in response. Moreover, eliminating all three of those deductions would raise revenues by less than the sum of the effects of eliminating each deduction, because if all of the deductions were gone, more taxpayers would claim the standard deduction (instead of itemizing deductions) than would be the case if any single deduction was repealed.¹⁵

Itemized deductions provide the largest benefits—in both absolute dollars and relative to income—to the highest-income taxpayers. Those tax expenditures benefit only the roughly one-third of taxpayers who itemize their

deductions, and lower-income taxpayers are much less likely than higher-income taxpayers to do so. Additionally, the value of deductions rises as taxpayers move into higher tax brackets: A taxpayer in the 15 percent tax bracket who itemizes deductions saves \$150 in taxes by making a \$1,000 charitable contribution, but the same contribution reduces the tax bill of a taxpayer in the 39.6 percent tax bracket by \$396. CBO estimates that the tax benefit of those three deductions in 2013 will equal less than 0.1 percent of after-tax income for the lowest income quintile, 0.4 percent for the middle quintile, 2.5 percent for the highest quintile, and 3.9 percent for the top percentile (see Table 2 on page 15).

State and Local Taxes. The state and local tax deduction—estimated at about \$80 billion in 2013—is the biggest of the three deductions that CBO examined. It provides a much larger benefit relative to income for higher-income households than for lower-income households. For 2013, CBO estimates that this deduction will account for less than 0.1 percent of after-tax income for households in the lowest income quintile, 0.2 percent for those in the middle quintile, and 1.4 percent for those in the highest quintile.

Mortgage Interest on Owner-Occupied Residences.

The deduction for interest paid on mortgages for owner-occupied residences, which CBO estimates will equal \$70 billion in 2013, is the next-largest itemized deduction. It is also the least tilted toward the top of the income distribution, in part because the law caps the maximum mortgage amount on which interest payments can be deducted (generally limited to the first \$1 million of mortgage debt) and in part because mortgage debt rises less rapidly with income than do other deductible expenses. Nonetheless, the tax expenditure still benefits

15. The ultimate incidence of this tax expenditure is uncertain. The exclusion could narrowly benefit either decedents or their heirs, or the exclusion could have much broader effects on labor and capital income by affecting saving behavior, much like other taxes on capital income. CBO allocates the tax to decedents; it calculates the value of the tax expenditure by first estimating the tax that each household would owe if a member died and then multiplying that amount by each member's probability of death. Other researchers who have examined the distribution of the estate tax have found that the distribution is highly progressive regardless of whether the burdens are allocated to decedents or to heirs. For example, see Lily L. Batchelder and Surachai Khittatrakun, "Dead or Alive: An Investigation of the Incidence of Estate and Inheritance Taxes" (paper presented at the Third Annual Conference on Empirical Legal Studies, Ithaca, N.Y., September 12–13, 2008), <http://dx.doi.org/10.2139/ssrn.1134113>.

16. The limit on itemized deductions, which was reinstated in 2013, contributes to that interaction among deductions. The limit reduces allowable itemized deductions for taxpayers with adjusted gross income (AGI) above \$250,000 (\$300,000 for joint filers) by 3 percent of the excess of AGI over that threshold, up to a maximum reduction equal to 80 percent of itemized deductions. Because the limit depends on the amount of income above the threshold, it is unaffected by the amount of deductions, except for the small number of taxpayers with deductions low enough to trigger the 80 percent limit. Repealing any one of the three itemized deductions analyzed here would have little effect on the limit, because most high-income people would still have enough deductions that the 80 percent limit would not be triggered; however, repealing all three of those deductions would trigger the 80 percent limit for many more taxpayers.

higher-income households much more than other households. CBO estimates that the top quintile will receive almost three-quarters of the benefit of the deduction in 2013, including 15 percent accruing to the top percentile. The mortgage interest deduction will equal less than 0.1 percent of after-tax income for households in the lowest income quintile, 0.3 percent for those in the middle quintile, and 1.1 percent for those in the highest quintile, CBO estimates.

The tax expenditure for the mortgage interest deduction varies over time with the rate of home ownership and interest rates. CBO expects that interest paid on owner-occupied housing will be about 25 percent lower in 2013 than it was in 2006, the year before housing prices began to decline. Had mortgage interest payments held steady at the 2006 share of households' income, the size of this tax expenditure would be roughly 50 percent larger in 2013 than the current estimate.

Charitable Contributions. The deduction for charitable contributions will equal about \$40 billion in 2013, CBO estimates. Higher-income households tend to contribute a greater share of their income to charity and to receive a larger subsidy per dollar contributed. Consequently, the benefits of this tax expenditure are concentrated among those households, with the top quintile receiving more than 80 percent of the tax expenditure, including 38 percent for the top percentile. CBO estimates that, in 2013, the tax expenditure will equal just 0.1 percent of after-tax income for households in the middle quintile, 0.7 percent for those in the highest quintile, and 1.4 percent for the top percentile.

Preferential Tax Rates

Some forms of income are subject to preferential tax rates under the income tax. In particular, long-term capital gains and dividends are taxed at lower rates than are other forms of income. (Although lower tax rates on investment income are considered tax expenditures relative to a pure income tax, investment income generally would be excluded from taxation under a consumption tax; thus, those lower rates would not be viewed as a tax expenditure relative to that benchmark.) Currently, long-term capital gains and dividends are subject to a 20 percent maximum tax rate for taxpayers subject to the top (39.6 percent) marginal tax bracket on ordinary income, a 15 percent maximum rate for taxpayers in the 25 percent through 35 percent tax brackets, and a rate of zero

for taxpayers in the 10 percent and 15 percent marginal tax brackets.

Beginning in 2013, taxpayers with income over certain thresholds—\$200,000 for single filers and \$250,000 for joint filers—will face a surtax equal to 3.8 percent of their investment income (including capital gains and dividend income as well as interest income and some passive business income). That surtax, enacted as part of the Affordable Care Act, effectively reduces the preferential rate on dividends and capital gains. JCT treats the surtax as a negative tax expenditure—that is, a deviation from the reference tax system that increases rather than decreases taxes. CBO's estimates of the preferential rates do not include the effect of the surtax. In CBO's estimation, the surtax on all income subject to the tax, not just capital gains and dividends, will raise revenues by roughly \$17 billion in 2013. The surtax overwhelmingly affects high-income taxpayers, with 91 percent of the surtax falling on the top percentile of the income distribution and the rest on the 96th through 99th percentiles.

The tax expenditure from the preferential rates on long-term capital gains and dividends will be roughly \$85 billion in 2013, CBO estimates. That estimate is based on current amounts of dividends paid out by corporations and capital gains realized by individuals. If the preferential rates on those forms of income were eliminated, corporations would alter the amounts of dividends they paid and individuals would alter the amount of capital gains they realized, so the increase in tax revenues would be smaller than \$85 billion. In anticipation of the higher tax rates that were scheduled to take effect in 2013, individuals and corporations probably shifted back into 2012 a significant amount of capital gains realizations and dividends that otherwise would have been realized or paid in 2013. CBO estimates that such shifting reduced the size of the tax expenditure in 2013 (measured as calendar-year tax liabilities) by roughly 20 percent.¹⁷

Virtually all of the benefits from the preferential tax rates on those sources of income accrue to the top quintile of households. The tax expenditure for that group will equal 1.7 percent of their after-tax income in 2013, CBO

17. That shifting makes the fiscal year 2013 tax expenditure much larger than the calendar year 2013 tax expenditure, because taxes on most gains realized in calendar year 2012 are paid in fiscal year 2013.

Box 1.**Health Insurance Exchange Subsidies**

The Affordable Care Act provides subsidies to help low- and moderate-income people purchase health insurance through new health insurance exchanges, which are scheduled to begin operating in 2014. Individuals and families with household income between 100 percent and 400 percent of the federal poverty guidelines, who do not have access to affordable employment-based health insurance, who are not eligible for Medicaid or the Children's Health Insurance Program, and who meet certain other requirements may receive a premium assistance tax credit to cover some of the cost of a health insurance plan purchased through an exchange. That subsidy program is designed so that eligible people with relatively low income will receive greater benefits than those with higher income. The credit will equal the difference between a reference premium amount and a specified percentage of income, initially ranging from 2.0 percent for people with income below 133 percent of the federal poverty guidelines to 9.5 percent (for people with income between 500 percent and 400 percent of the federal poverty guidelines).¹

The Congressional Budget Office (CBO) and the staff of the Joint Committee on Taxation (JCT) project that the tax expenditure for premium assistance credits will be 0.2 percent of gross domestic product, or GDP (\$41 billion), in fiscal year 2015. Participation in the exchanges is expected to ramp up quickly over the following years, bringing the expenditure up to 0.5 percent of GDP (\$95 billion) in 2017. CBO and JCT expect it to remain around 0.5 percent of GDP from 2018 through 2023.

Because the distributional analysis in this report evaluates tax expenditures only in calendar year 2013, it does not consider the tax expenditure for exchange subsidies. Analysis of subsequent years, when the exchange subsidies were in effect, would show those subsidies accruing mainly to households in the bottom two-thirds of the income distribution. However, because many of the lowest-income taxpayers will be eligible for Medicaid, they will not benefit from the tax expenditure.

1. For more information, see Congressional Budget Office, *Additional Information About CBO's Analysis of Premium Tax Subsidies for Health Insurance Purchased Through Exchanges* (May 2011), www.cbo.gov/publications/01466.

estimates (see Table 2 on page 15). Within the top quintile, the tax expenditure is heavily concentrated in the top 1 percent of households, because a large share of investment income in the form of capital gains realizations and dividends accrues to those taxpayers. The top 1 percent of households will receive more than two-thirds of the total value of the benefit in 2013, CBO estimates, which will equal 5.3 percent of their after-tax income.

Tax Credits

The other major tax expenditures included in this analysis are two tax credits, both generally targeted toward households with children. CBO projects that tax expenditures for the earned income tax credit and the child tax credit will be about \$60 billion each in 2013.¹⁸ Both credits were significantly expanded in 2001 and again in later years, but the expansions enacted since 2008 are

scheduled to expire at the end of December 2017; thus, under current law, the impact of those two credits will decline modestly in the future.

Credits for participating in health insurance exchanges are not included in the distributional analysis because they are not in effect in 2013. Those credits are expected to be substantial in subsequent years, however (see Box 1).

CBO estimates that, taken together, the benefits of the two credits in 2013 will equal 8.1 percent of after-tax

18. The estimates for the earned income tax credit and child tax credit include the refundable portions of the credits (the amounts in excess of income tax liability), which are recorded as outlays in the federal budget.

income for households in the lowest income quintile, 1.5 percent for those in the middle quintile, and just 0.1 percent for those in the highest quintile (see Table 2 on page 15). Several features of the credits lead to that distributional pattern. First, both credits have a fixed maximum value, making them a smaller share of income as income rises (in contrast to exclusions or deductions, which are uncapped and can rise with income). Second, both credits phase out to zero as income rises beyond certain thresholds, making higher-income taxpayers ineligible for the credits.¹⁹ Finally, both credits are refundable, so taxpayers need not owe income taxes in order to claim the credits; that refundability allows the lowest-income households to benefit from the credits. Because the child tax credit phases out at higher income thresholds than the earned income tax credit and because its refundability is more limited, the child tax credit is less concentrated at the bottom of the income distribution.

The earned income tax credit is much larger for families with children than for childless workers, and the child tax credit is only available to families with children, so estimates of the distribution of the credits depend critically on the distribution of families with children across the

income scale. When ranking the population by income, CBO adjusts household income for family size; as a result, more families with children are included in the bottom income quintile.²⁰ Without such an adjustment, the tax credits would appear less progressive than they do in this report.

Earned Income Tax Credit. In 2013, more than half of the earned income tax credit will accrue to households in the bottom quintile of the income distribution, CBO estimates; for those households, the credit will equal 5.8 percent of their after-tax income. An additional 29 percent of the credit will accrue to households in the second quintile, for whom the credit will equal 1.7 percent of their after-tax income (see Table 2 on page 15). In contrast, the top two quintiles of households will receive just 9 percent of the benefits from the earned income tax credit, and as a consequence, the credit has a very small effect relative to their after-tax income.

Child Tax Credit. The child tax credit is concentrated in the middle of the income distribution, with households in the second and third quintiles receiving the largest shares. CBO estimates that, in 2013, the credit will be 2.3 percent of after-tax income for households in the lowest income quintile, 0.9 percent for those in the middle quintile, and 0.1 percent for those in the highest quintile.

19. Despite income restrictions, households in the top two quintiles of the income distribution may receive the credits in certain cases, because households may include multiple families or tax filers. For example, a household may include a family consisting of one low-income parent and two children that is eligible for the earned income and child tax credits and a higher-income adult whose income places the entire household at the top of the income distribution.

20. For an explanation of CBO's adjustment for household size, see Congressional Budget Office, *The Distribution of Household Income and Federal Taxes, 2008 and 2009* (July 2012), www.cbo.gov/publication/43373.



Appendix: Additional Features of the Estimates

Six aspects of the estimates of tax expenditures presented in this report merit further discussion. First, the Congressional Budget Office's (CBO's) estimation approach incorporates the assumption that, in the absence of a single tax expenditure, taxpayers would make use of other tax provisions that might generate tax expenditures. Second, the estimates do not represent the amount of revenue that would be raised if the associated tax provisions were eliminated, because they do not account for the behavior of taxpayers. Third, tax expenditures may affect people other than those who claim them (and have different effects on people who claim the same amounts); however, CBO allocates the dollar amounts claimed to the people who claim them. Fourth, the estimates in this report include interactions among the tax expenditures that CBO considered. Fifth, CBO's analysis of payroll taxes does not include effects on future Social Security benefits related to payroll taxes paid. Sixth, the tax expenditure for net pension contributions and earnings differs from the other tax expenditures considered in this report because it arises from a significant alteration in the timing of tax payments.

Estimation Approach

To evaluate the distribution of tax expenditures, CBO used a sample of income tax returns filed in 2006 (the most recent public-use data with detailed tax return information that was available at the time of the analysis) and extrapolated those returns to 2013 to account for actual and projected changes in income and demographics. CBO calculated a broad measure of before-tax income, including both market income (such as labor income, business income, and capital income) and government transfer payments (such as Social Security benefits).¹

In this analysis, CBO presents results for various subgroups of the population, such as the lowest quintile

or the top 1 percent. In constructing those subgroups, households (all people living in a single housing unit) are ranked by income that is adjusted for household size, to reflect the fact that larger households need more income than smaller households to achieve the same economic status. CBO adjusted for household size by dividing household income by an adjustment factor equal to the square root of the number of people in the household, counting adults and children equally. That adjustment implies that each additional person increases a household's needs but at a decreasing rate. Table A-1 presents the range of income for households of different sizes in each category of before-tax income that CBO uses in the study.

CBO then simulated what tax liabilities would have been for each taxpayer in 2013 in the absence of the provisions generating tax expenditures but not accounting for any change in taxpayers' behavior in response to eliminating those provisions. Each estimated tax expenditure for each taxpayer was scaled so that the sum of estimates across taxpayers for a given tax expenditure matched the aggregate amount of that tax expenditure as estimated by the staff of the Joint Committee on Taxation (JCT).

In this report, CBO follows JCT's approach and measures each tax expenditure "by the difference between tax liability under present law and the tax liability that would result from a recomputation of tax without benefit of the tax expenditure provision."² Taxpayers are assumed to take advantage of any of the remaining tax expenditure

1. For information about how CBO estimates the distribution of taxes and household income, see Congressional Budget Office, *The Distribution of Household Income and Federal Taxes, 2008 and 2009* (July 2012), www.cbo.gov/publication/43373.
2. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017*, JCS-1-13 (February 1, 2013), p. 23, www.jct.gov/publications.html?func=fileinfo&id=4503.

Table A-1.**Minimum Income for Different Income Groups, by Household Size, 2013**

(Dollars)

	Lowest Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Highest Quintile	Percentiles Within the Highest Quintile			
						81st to 90th	91st to 95th	96th to 99th	Top 1
One-Person Household	0	24,700	38,500	55,100	81,400	81,400	110,500	148,200	327,000
Two-Person Household	0	35,000	54,400	77,900	115,100	115,100	156,200	209,500	462,500
Four-Person Household	0	49,500	77,000	110,200	162,800	162,800	220,900	296,300	654,000

Source: Congressional Budget Office.

Notes: Income categories are created by ranking all households by their before-tax income. Percentiles (hundredths) and quintiles (fifths) contain equal numbers of people.

Income amounts have been rounded to the nearest \$100.

provisions that apply to the income or the expenses associated with the tax expenditure in question. For example, the tax expenditure for the exclusion of employer-sponsored health insurance is estimated as the difference in tax liability if the exclusion was repealed but taxpayers were still allowed to claim the next-best tax treatment available under current law for health insurance contributions; for some taxpayers, that next-best treatment would be to claim those contributions as an itemized medical deduction.

Differences Between Tax Expenditures and Revenue Estimates

Estimates of tax expenditures are intended to mirror budget totals for traditional government spending programs, which represent spending amounts given current law and behavior. Estimates of tax expenditures do not equal the additional revenues that would be raised if tax provisions were repealed, just as CBO's projections of spending for different programs under current law do not equal the reduction in spending that would occur if those programs were eliminated. For example, the reduction in spending that would result from the elimination of one program (such as Disability Insurance) could be offset somewhat by increased spending for other programs (such as Supplemental Security Income, which provides cash assistance to people with low income and few assets who are also disabled). Although that offset would be included in a CBO estimate of the budgetary effect of repealing a program, it is not reflected in budget projections for that program.

The change in incentives that would result from repealing a particular tax provision that generates a tax expenditure would lead taxpayers to modify their behavior in ways that would generally make the revenue impact of the repeal smaller than the tax expenditure. For example, if the preferential tax rates on capital gains were eliminated, taxpayers would reduce the amount of capital gains they realized. Because that tax expenditure is projected on the basis of the gains that are expected to be realized with the preferential rates in place, the amount of additional revenues that would be received if those preferences were eliminated would be smaller than the estimated tax expenditure.

Incidence of Tax Expenditures

The economic incidence of a tax is the change in the distribution of individual welfare that results from the tax. Behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report.

Taxpayers in different income groups may be more or less able to adjust their behavior in response to provisions of law, and even households not directly affected by tax expenditures might be affected by their existence. For example, the estimated tax expenditure for the deduction of mortgage interest does not incorporate any adjustments by taxpayers in the amount of mortgage debt they hold or any impact on housing values. However, affluent taxpayers with other significant assets might hold more mortgage debt than they would

otherwise because mortgage interest receives preferential tax treatment. Furthermore, the value of the deduction is probably built into housing prices, so even homeowners who do not hold mortgage debt or currently claim the deduction for mortgage interest may benefit from the deduction.³ However, the estimates in this report attribute the benefit from that tax expenditure to taxpayers entirely on the basis of the mortgage interest deduction they claim.

Interactions Among Provisions

Estimated tax expenditures in this report include the interactions that would arise if multiple tax expenditures were set aside at the same time. For instance, eliminating a particular income tax exclusion would increase taxable income, pushing some income into tax brackets with higher marginal rates. Eliminating *all* income exclusions would increase taxable income by the sum of the individual increases (leaving aside other considerations); but because of the structure of tax brackets and marginal rates, a larger share of that additional income would end up in tax brackets facing higher marginal rates. As a result, the budgetary effect of eliminating all exclusions would be larger than the sum of the effects of eliminating each exclusion separately. Conversely, eliminating all itemized deductions would have a smaller effect than the sum of the estimates for eliminating each deduction, because with all of the deductions gone, more taxpayers would claim the standard deduction (instead of itemizing deductions) than would be the case if any single deduction was repealed.

For the entire group of tax expenditures examined here, such interactions would largely offset one another, subtracting less than 2 percent from the total size of the expenditures, CBO estimates. However, interactions among certain subsets of provisions may be substantial.

Effects of Including Payroll Taxes

The exclusions for employer-sponsored health insurance and net pension contributions and earnings not only reduce income subject to the income tax but also reduce

earnings subject to the payroll taxes for Social Security (Old-Age, Survivors, and Disability Insurance, or OASDI), and Medicare's Hospital Insurance (HI) program. The estimates in this report of the exclusions for employer-sponsored health insurance and pension contributions include that effect on payroll taxes. In contrast, estimates of tax expenditures published by JCT and the Treasury generally include only the effects on income taxes.⁴

Exclusions from payroll taxes also generally reduce future OASDI benefits, which are determined by a person's lifetime earnings subject to Social Security taxes. The exclusions are unlikely to have much effect on future HI benefits, because all workers meeting the eligibility requirements for the HI program are eligible for the same benefits. An ideal measure of the effect of the exclusions on Social Security payroll taxes might subtract the present value (a single number that expresses a flow of current and future payments in terms of a lump sum paid today) of the expected incremental benefits from the amount of the tax in the current year, but CBO's estimates do not include any effects on future benefits. Including those effects would mute the budgetary cost of the exclusions.

Researchers who have studied the implicit marginal tax rate on earnings—taxes paid minus the present value of benefits—in the Social Security system find that the rate varies considerably depending on a worker's circumstances.⁵ Some workers' implicit marginal tax rate equals the statutory OASDI rate, because they pay tax but

3. For a discussion of the potential behavioral effects associated with repeal of the mortgage interest deduction, see Adam J. Cole, Geoffrey Gee, and Nicholas Turner, "The Distributional and Revenue Consequences of Reforming the Mortgage Interest Deduction," *National Tax Journal*, vol. 64, no. 4 (December 2011), pp. 977–1000, <http://ntj.tax.org>.

4. JCT has previously estimated the effect on payroll taxes of the provision that excludes employers' contributions for health insurance premiums from workers' taxable income. See Joint Committee on Taxation, *Background Materials for Senate Committee on Finance Roundtable on Health Care Financing*, JCX-27-09 (May 8, 2009), www.jct.gov/publications.html?func=filinf&cid=3557. The Treasury provides estimates of the effect on payroll taxes of the exclusion of employers' contributions for health insurance in a footnote to Table 17-1 in Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2013: Analytical Perspectives* (February 2012), Chapter 17, www.gpo.gov/fdsys/search/pagedetails.action?granuleld=&packageId=BUDGET-2013-PER.

5. See Gopi Shah Goda, John B. Shoven, and Sita N. Slavov, "Removing the Disincentives in Social Security for Long Careers," in Jeff Brown, Jeff Liebman, and David A. Wise, eds., *Social Security Policy in a Changing Environment* (University of Chicago Press, 2009), pp. 21–38, www.nber.org/books/brow08-1; and Martin Feldstein and Andrew Samwick, "Social Security Rules and Marginal Tax Rates," *National Tax Journal*, vol. 45, no. 1 (March 1992), pp. 1–22, <http://ntj.tax.org>.

receive no additional benefits from additional earnings. But other workers face a much lower, or even negative, marginal tax rate on their additional earnings (a negative marginal rate implies that the present value of benefits accruing from additional earnings exceeds the Social Security payroll taxes paid on those earnings). Importantly, because the Social Security system replaces a larger share of earnings for low-earning workers than for high-earning workers, high-earning workers face a higher implicit tax rate from Social Security than do low-earning workers. Thus, a full accounting of payroll taxes and Social Security benefits would probably make the distribution of the exclusions for employer-sponsored health insurance and net pension contributions appear more progressive than the current analysis, which examines only the tax effects. However, because other factors besides earnings are important for future Social Security benefits—age, sex, career length, and marital status also affect the implicit tax rate—the effects of the exclusions on future benefits are difficult to estimate.

An Alternative Method for Valuing Pensions

Pension contributions are excluded from income and payroll taxes when they are made, and investment earnings in pension plans are not taxed under the income tax. Income taxes are not avoided altogether (although the payroll taxes on contributions are); instead, they are deferred until funds are distributed from retirement plans. The traditional approach to estimating this tax expenditure, used in this report, measures the effect of all current and past pension contributions on current tax revenues. An alternative approach is to measure the effect of current contributions on current and future taxes.

Using the traditional approach, CBO estimated the tax expenditure for pension contributions as the difference between the current tax treatment and an alternative in which there was no deduction for contributions, investment earnings in existing accounts were taxed, and withdrawals from existing accounts were not taxed. Thus, the tax expenditure has three distinct components: the taxes forgone on current contributions, the taxes forgone on investment earnings of past contributions, and the taxes collected on pension benefits (which partially offset the first two components).

Under an alternative approach, the current and future taxes paid for retirement contributions made today are compared with the current and future taxes that would have been paid on an equivalent investment in a taxable account. Because the tax benefits from current pension contributions occur over many years, the tax benefit of the exclusion is best measured as a present value.⁶ That approach calculates the entire future stream of tax payments for an investment in a pension account (in general, contributions to retirement accounts and investment earnings are not taxed but withdrawals are) and the stream of tax payments for an investment in a taxable account (in which contributions and investment earnings are taxed but withdrawals are not). Those two payment streams are then converted into 2013 dollars, and the tax expenditure is valued as the difference. Calculating the present value of tax savings for current retirement contributions requires making many assumptions, however. The value is especially sensitive to assumptions about the rate of return on investment earnings and the tax rate that would apply to those earnings.⁷

In CBO's estimation, the tax expenditure for net pension contributions and earnings measured as the present value of one year's retirement contributions would be roughly 10 percent lower than the tax expenditure measured in the traditional way (as presented in this report). The present-value measure of the tax expenditure would also be slightly more progressive than the traditional measure. Households in the bottom three income quintiles would receive 18 percent of the tax expenditure

6. The Treasury also provides present-value estimates for tax expenditures related to deferrals of income, including expenditures for retirement savings and accelerated depreciation of property. See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2013: Analytical Perspectives* (February 2012), Chapter 17, Table 17-4, www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/spec.pdf.

7. CBO's calculations incorporate the following assumptions: Pension contributions remain in tax-preferred plans until taxpayers reach age 65, at which point those contributions are withdrawn in equal installments until taxpayers reach age 85; investments earn a 5 percent before-tax rate of return, of which one-quarter is interest and the remainder is evenly split between dividends and capital gains; capital gains taxes are deferred, with an average holding period of seven years, and are taxed at a preferential rate; future taxes are discounted using a 5 percent discount rate; and each taxpayer would face the same marginal tax rate in retirement as he or she faces today.

under the present-value method, compared with 16 percent under the traditional method. The fourth quintile would receive 24 percent of the benefits under the present-value method, compared with 18 percent under the traditional method, and the top income quintile would receive 58 percent under the present-value method, versus 66 percent under the traditional method. Another important difference between the two methods involves distribution by age: Under the present-value method, younger workers benefit more, and older workers benefit less, than they would under the traditional method.

Using the present-value method to measure current retirement contributions would have little effect on the overall distribution of the tax expenditures studied here, because pensions are less than one-fifth of total tax expenditures and because the distribution of the pension tax expenditure under the present-value and traditional methods does not differ greatly. Under the present-value method, the share of total tax expenditures received by the highest income quintile would fall by about 1 percentage point, and the share received by the four lowest quintiles would increase slightly.

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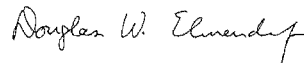
About This Document

This Congressional Budget Office (CBO) report was prepared at the request of the Ranking Member of the House Committee on the Budget. In keeping with CBO's mandate to provide objective, impartial analysis, the report makes no recommendations.

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Douglas W. Elmendorf
Director

May 2013

**Individual Retirement Savings Outcomes:
The Role of Incentives, Plan Design, and Behavioral Economics**

Remarks by

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Prepared for the Hearing

“Retirement Savings 2.0: Updating Savings Policy for the Modern Economy”

SENATE COMMITTEE ON FINANCE

Tuesday, September 16, 2014

Thank you for the opportunity to speak to you today and share my thoughts on how we can strengthen America's retirement savings system. By way of background, I am the Aetna Professor of Public Policy and Corporate Management at the Harvard University John F. Kennedy School of Government. I have spent the past 15 years studying individual savings behavior and the policy interventions and plan design features that impact savings outcomes.

Public policy has historically promoted private saving for retirement using financial incentives. In the United States, the primary inducement to save is the exemption of retirement savings plan contributions (up to a limit) from taxable income. The Joint Committee on Taxation places the magnitude of this tax expenditure in 2014 at \$127.2 billion annually (Joint Comm. Tax. 2013). Lower-income taxpayers are also eligible for the Saver's Credit, as a further enticement to save. In addition, public policy encourages employers who sponsor retirement savings plans to provide their own financial inducements for employees to save, namely the provision of an employer match.

A large body of literature has examined the responsiveness of savings to financial incentives. A rather consistent finding from this literature is that the behavioral response to changes in incentive to save is not particularly large. In a recent paper, I surveyed the academic literature on the impact of one kind of financial incentive, matching, on savings plan participation and contributions. The studies using the most credible empirical methods find strikingly similar results in a variety of different contexts using a variety of different data sources: A matching contribution of 25% increases savings plan participation by roughly 5 percentage points. This is a modest effect at best.

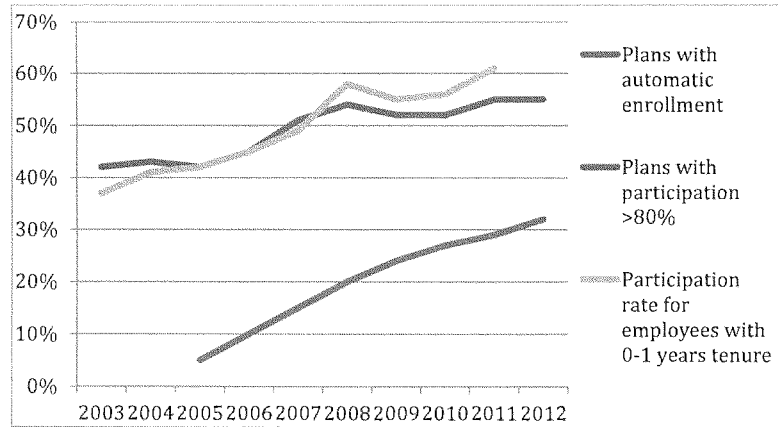
Conditional on participating in a savings plan, financial incentives can impact how much individuals save. But this effect does not come from the magnitude of the financial incentive so much as from the fact that at some point the incentive expires. For example, in many 401(k) plans, the employer provides a match, but only up to a certain fraction of pay, say 6%. The Saver's Credit gives eligible low and moderate income households a financial incentive to save for retirement, but only for the first \$2000 contributed to an IRA or workplace savings plan. When financial incentives to save are limited to savings below a certain threshold, this threshold becomes a focal point as individuals decide how much to save. For example, data from 401(k) plans shows that savings plan participants overwhelmingly choose contribution rates that are either multiples of 5 (5%, 10%, 15%) or the match threshold. This finding suggests that the match threshold may be a much more important parameter in a matching scheme than the match rate.

The relatively small impact of financial incentives on savings plan participation suggests that a failure to save is not primarily the result of inadequate financial incentives. Rather, there are other barriers to saving not addressed by traditional policy solutions. The literature on behavioral economics and savings outcomes points to a myriad of frictions that impede

successful savings outcomes: procrastination, a lack of financial literacy coupled with the complexity of determining how much to save and how to best to invest for retirement, inattention, and the temptation to spend. In many cases, countering these frictions leads to increases in savings plan participation and asset accumulation that surpass the effects of financial incentives.

Before discussing policy alternatives to financial incentives that are informed by behavioral economics, let me note that from a behavioral economics standpoint, the tax code is particularly ill-suited to generating financial incentives to save. First, the tax code is complicated. It is difficult for the average taxpayer to even assess the financial incentives he or she faces through the tax code. For example, in a research project that I am working on, my coauthors and I have found that most individuals do not accurately understand the tax implications of saving in a Roth vs. a regular 401(k) or IRA. For a low or moderate income taxpayer, assessing the incentives of the Saver's Credit without the help of a tax professional would likely be a daunting task, indeed, I attempted to do so in preparing these remarks and gave up after 10 minutes on the IRS website! Second, individuals are more responsive to immediate than to delayed financial incentives, but many of the financial incentives to save that operate through the tax code are delayed. The benefits of tax deferred compounding are delayed, as are the benefits of tax deductions or credits that aren't processed through payroll deduction to reduce tax withholding throughout the year. Ironically, what could perhaps be a very effective financial incentive to encourage individuals to enroll in a workplace savings plan—a small but immediate financial reward—is actually not allowed in 401(k) or 403(b) plans under current law.

If financial incentives are not a savings panacea, what is? By far the most effective method to increase savings plan participation is automatic enrollment. Savings plan participation rates are substantially higher when the default is enrollment in the savings plan (that is, individuals must opt out if they prefer not to save) than it is when individuals must take action to participate in the savings plan. The impact of automatic enrollment on participation rates can be sizable and is greatest for groups with the lowest savings rates initially: younger and lower-income workers. The Pension Protection Act of 2006 has successfully encouraged a rapid expansion in the number of employers using automatic enrollment in their savings plans, and this has resulted in an increase savings plan participation rates.



Source: Vanguard (2013), "How America Saves: 2013."

The success of automatic enrollment in employer-sponsored savings plans results from two factors: (a) individuals recognize the need for retirement income above and beyond what they will get from Social Security and therefore want to save, and (b) automatic enrollment simplifies what individuals already want to do. Other initiatives that simplify the savings process have also been shown to increase savings plan participation substantially, although not to the same degree as automatic enrollment. For example, "Quick Enrollment" tools that provide individuals with a pre-selected contribution rate and asset allocation bundle that they can easily opt into have been shown to increase participation rates by 10-20 percentage points.

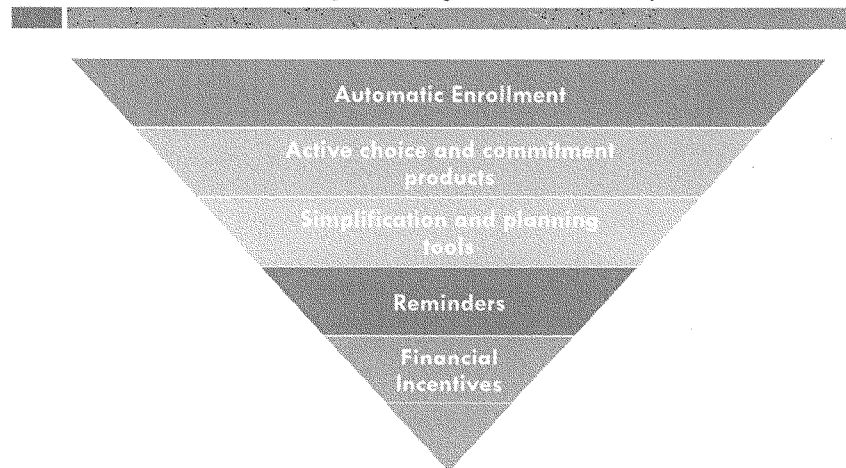
Expanding the reach of automatic enrollment is the most promising policy step we can take to increase the fraction of Americans who are saving for retirement. This means continuing to increase the number of employers with savings plans who use automatic enrollment, increasing the number of employers who offer a savings plan to their employees by providing a simple and low cost way for small employers to offer a savings plan (only half of workers are in a job where they are even eligible to participate in a savings plan), and providing simple savings alternatives for individuals who are self employed or whose employers do not and are unlikely to ever sponsor a savings plan. Policy initiatives that support these measures include auto-IRA proposals and legislation to facilitate the creation of multiple employer plans with limited fiduciary liability.

Paradoxically, we have a savings system that, in the absence of automatic enrollment, makes saving complicated while at the same time making it very easy for individuals to tap into their retirement savings well before retirement. Another policy response to encourage retirement

wealth accumulation is to reduce the leakage from our retirement savings system by discouraging pre-retirement distributions. A sizeable fraction of individuals completely cash out their retirement savings plan balances when they change jobs, and many others roll their money into IRAs where fees are often higher than in employer sponsored plans. Measures to reduce the impact of leakage include facilitating 401(k) loan repayments even after individuals have left an employer where they had taken out a loan, limiting the amount that individuals can withdraw before retirement, and increasing the penalties on pre-retirement withdrawals.

In conclusion, the lessons from the behavioral economics research are clear: if you want individuals to save, make it easy. If you want individuals to save more, make it easy. If you want employers to help their workers save, make it easy. And if you want individuals to spend less, make it hard!

The “Bang for the Buck” of Different Approaches to Increasing Savings Plan Participation



Source: Madrian (2013). Matching Contributions and Savings Outcomes: A Behavioral Economics Perspective.

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Statement of the Investment Company Institute
Brian Reid, Chief Economist
Hearing on “Retirement Savings 2.0: Updating Savings Policy for the Modern Economy”
Committee on Finance
United States Senate
September 16, 2014

The Investment Company Institute¹ is pleased to provide this written statement in connection with the hearing in the U.S. Senate Committee on Finance titled “Retirement Savings 2.0: Updating Savings Policy for the Modern Economy.” The Institute strongly supports efforts to promote retirement security for American workers. We thank Chairman Wyden and Ranking Member Hatch for their past support of bipartisan retirement savings plan improvements, including provisions in the Pension Protection Act of 2006 (PPA) which made permanent the increased contribution limits and catch-up contributions for older workers introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Thanks in no small part to Congress’ efforts to promote retirement savings, Americans currently have \$23.0 trillion earmarked for retirement, with more than half of that amount in defined contribution (DC) plans and individual retirement accounts (IRAs).² About half of DC plan and IRA assets is invested in mutual funds, which makes the mutual fund industry especially attuned to the needs of retirement savers.

The Institute has devoted years of research and considerable resources to making and communicating an accurate assessment of America’s retirement system.³ We are concerned that those

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$17.1 trillion and serve more than 90 million shareholders.

² At the end of the first quarter of 2014, U.S. retirement assets totaled \$23.0 trillion, DC plan assets were \$6.0 trillion and IRA assets were \$6.6 trillion. See Investment Company Institute, “The U.S. Retirement Market, First Quarter 2014” (June 2014), available at www.ici.org/info/rer_14_q1_data.xls.

³ One of the major roles the Institute serves is as a source for statistical data on the investment company industry. With a research department comprising more than 40 people, including seven PhD-level economists, the Institute conducts public policy research on fund industry trends, shareholder characteristics, the industry’s role in U.S. and international financial markets, and the retirement market. For example, the Institute publishes reports focusing on the overall U.S. retirement market, fees and expenses, and the behavior of defined contribution (DC) plan participants and IRA investors. In its research on mutual fund investors, IRA owners, and 401(k) plan participants, the Institute conducts periodic household surveys that connect directly with savers.

who attempt to paint the current system as “broken” all too often proceed by isolating one component of the system or by focusing solely on account balances. But that is not how Americans plan and prepare for retirement. The U.S. retirement system relies upon the complementary components of Social Security, homeownership, employer-sponsored retirement plans (both defined benefit (DB) plans and DC plans offered by both private-sector and government employers), IRAs (both contributory and rollover), and other savings.

In retirement, different households will depend on each of these components in differing degrees, subject to overall saving levels, work history, and other factors. For most households, however, employer-sponsored retirement plans are crucial: about 8 in 10 near-retiree households have retirement assets (DC plans or IRAs), DB benefits, or both.⁴ Thanks to this multi-faceted system, successive generations of American retirees have been better off than previous generations.⁵

Even with its many successes, the U.S. retirement system can be strengthened further to help even more Americans achieve a secure retirement. The Institute supports policies that would improve access to retirement savings opportunities and make retirement plans more efficient and effective. These reforms would build upon the strengths of the current system. Unfortunately, many critics do not appear interested in building upon our current voluntary system—they want to tear it down, often relying upon selective information and overheated rhetoric to support their efforts. Claims that Americans are facing “pension poverty,” for example, are not used to bolster tax incentives for savings, but, rather, are cited to justify efforts to scrap the current system, limit or eliminate tax incentives, or create new and untested schemes that would take control over retirement preparedness away from Americans and their employers. As our research demonstrates, Americans do not want to lose that control, and employer-sponsored plans play an important role in preparing workers for retirement.

We commend this Committee for its willingness to look at the research and understand the facts in an effort to better assess Americans’ retirement prospects and the role that the current system plays in helping American workers reach their retirement goals. The Institute believes that a careful examination of the facts will lead this Committee to continue its support for policies that protect the tax incentives for retirement savings, improve the system, and help even more American workers achieve a secure retirement.

SUMMARY OF KEY POINTS

We have summarized the key points of our testimony below.

1. **While there is opportunity for improvement, the retirement system is working for millions of American workers.** A wide range of work by government, academic, and industry researchers who have carefully examined Americans’ saving and spending patterns, before and after

⁴ See Figure 13, p. 29, and Figure 14, p. 31, in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

⁵ *Ibid* (discussion, pp. 10–14).

retirement, shows that the American system for retirement saving is working for the majority of American workers and has grown stronger in recent decades.

- ***Americans' retirement resources are best thought of as a pyramid.*** The pyramid has five layers (Social Security, homeownership, employer-sponsored retirement plans, IRAs, and other assets), and the importance of each layer varies across households.
 - ***Effective policymaking requires a better understanding of the "coverage gap."*** Discussions about pension plan coverage often rely on misleading or incomplete coverage statistics. The fact is that the majority of private-sector workers needing and demanding access to pensions as part of their compensation have pension plan coverage. Efforts to expand coverage will be more successful if policymakers better understand the reasons underlying why specific populations are not participating in retirement savings vehicles.
 - ***The voluntary employer-provided retirement system is characterized by flexibility, competition, and innovation.*** A strength of the voluntary employer-sponsored retirement system is the flexibility built into its design. Combined with competition—among employers to offer attractive benefits packages that include retirement plans and financial services firms to provide services to those plans—this flexibility has led to tremendous innovation in retirement plan design over the past few decades and to continually lower costs for retirement products and services.
 - ***Retirement plan sponsors and investors are cost conscious and 401(k) plan assets tend to be concentrated in lower-cost mutual funds.*** At year-end 2013, 401(k) plans had \$4.2 trillion in assets and more than 60 percent of 401(k) plan assets were invested in mutual funds. Fees paid on mutual funds have trended down over the past two decades—both on mutual funds invested in 401(k) plans and industrywide—and investors tend to concentrate their assets in lower-cost funds.
2. **A deferral of tax is not equivalent to a tax exclusion or a tax deduction.** Exclusions and deductions reduce taxes paid in the year taken, but do not affect taxes in any future year. Tax deferrals—such as the deferral of tax on compensation contributed to an employer-sponsored retirement plan—reduce taxes paid in the year of deferral, but increase taxes paid in the year the income is recognized through distribution or withdrawal from a plan or account.
 - ***Tax deferral equalizes the incentive to save.*** The incentive to save is the after-tax return savers earn on their savings. By effectively taxing all investment income at a zero rate, tax deferral simply ensures that a dollar of 401(k) contributions earns the same after-tax return regardless of the tax bracket workers are in.
 3. **Vast majorities of U.S. households appreciate the tax treatment of DC plans and want to preserve the key features of DC plans.** Household survey data indicate that DC account—

owning households appreciate the tax advantages and investment features of DC plans. The tax incentives for retirement savings are vitally important in encouraging employers to create retirement plans and encouraging workers to participate. A vast majority of U.S. households, whether they have DC plans or IRAs, or not, reject the suggestion that DC plan contribution limits should be reduced. Reducing the tax incentives for retirement savings through employer plans or IRAs would undermine this system's foundation and put at risk our nation's progress on retirement security.

4. **Changes in retirement policy should build on the existing system—not put it at risk.** We urge this Committee to continue its leadership in pursuing policies to build on the strengths and successes of the U.S. retirement system. Any improvements, however, should preserve the tax incentives and other features that successfully encourage millions of Americans to accumulate savings during their working lives and therefore generate adequate income in retirement.
 - *The impact of proposals to reduce the tax benefits of employer-sponsored retirement plans would not be limited to taxpayers in the higher tax brackets.* Reducing the incentive for employers to offer plans will lead to fewer employers offering plans. Lower-paid workers—who were never the intended target of the proposals—would lose the many benefits of participation in employer-sponsored plans. In addition to tax deferral, lower-paid workers covered by a DC plan benefit from the convenience of payroll deduction, the “nudge” of automatic enrollment and auto-escalation, employer matches, and financial education—as well as the host of regulatory protections that surround employer-sponsored retirement plans.
 - *Proposals to limit the up-front tax benefit of deferral would substantially change the tax treatment of retirement contributions.* Proposals to “cap” the value of exclusions and deductions should not be applied to tax deferrals. Limiting the up-front benefit of tax deferrals would impact workers arbitrarily, substantially reducing benefits for those closest to retirement. In fact, some workers may find that they would be better off simply paying income taxes on their wages and investing in a taxable account.
 - *Limits on DC retirement plan contributions are already low by historical standards and should not be reduced further.* Adjusted for inflation, the current annual contribution limit to DC plans is less than half the limit originally established by the Employee Retirement Income Security Act of 1974 (ERISA).
 - *Proposals to limit the amount individuals could accumulate through the combination of aggregate retirement savings and DB plan benefit accruals are unworkable and would discourage plan formation.* Any proposal to place a dollar cap on individual retirement accumulations would add complexity to our nation's retirement system and would discourage employers from creating retirement plans and workers from participating.

I. THE U.S. RETIREMENT SYSTEM IS HELPING MILLIONS OF AMERICANS ACHIEVE A SECURE RETIREMENT

Retirement policy discussions often start from the premise that retirees' pension income has fallen over time. Contrary to this conventional wisdom, private-sector pension income has become more prevalent and more substantial—not less prevalent or less substantial—over time. Since the enactment of ERISA, increasing numbers of retirees receive benefits from private-sector pension plans (DB and DC) and receive more in benefits from these plans:

- Data from the Current Population Survey (CPS) show the share of retirees receiving private-sector pension income increased by more than 60 percent between 1975 and 1991, and has remained fairly stable since.⁶
- Among those receiving income from private-sector pensions, the median amount of inflation-adjusted income—which had remained fairly flat between 1975 and 1991—has increased nearly 40 percent between 1991 and 2012.⁷

Other evidence also points to retirees becoming better off over time.

- Poverty rates for people aged 65 or older have fallen over time. In 1966, the elderly poverty rate was nearly 30 percent. In 2012, it was 9 percent—and the elderly had the lowest poverty rate among all age groups.⁸
- Academic analysis has found that successive generations have reached retirement wealthier than the last.⁹

⁶ See Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA, 2012," *ICI Research Perspective* 19, no. 8 (October 2013), available at www.ici.org/pdf/per19-08.pdf.

⁷ *Ibid* (Figure 7 and Table 19 in the supplemental tables). The increase in pension income since ERISA is likely understated because the survey data used to analyze retiree income do not fully capture payments from DC plans and IRAs. See also Figure 20 and discussion, pp. 20–22, in Sabelhaus and Schrass, "The Evolving Role of IRAs in U.S. Retirement Planning," *Investment Company Institute Perspective* 15, no. 3 (November 2009), available at www.ici.org/pdf/per15-03.pdf.

⁸ See U.S. Census Bureau, "Living in Near Poverty in the United States: 1966–2012," *Current Population Reports*, available at www.census.gov/prod/2014pubs/p60-248.pdf. In 2012, the poverty rate for individuals aged 18 to 64 was 14 percent, while it was 22 percent for those younger than 18. For historical time series, see Brady, Burhan, and Holden, *The Success of the U.S. Retirement System*, Figure 6, p. 14.

⁹ See Haveman, Holden, Wolfe, and Romanov, "The Sufficiency of Retirement Savings: Comparing Cohorts at the Time of Retirement," *Redefining Retirement: How Will Boomers Fare?* Edited by Madrian, Mitchell, and Soldo: pp. 36–69, New York: Oxford University Press (2007); and Gustman, Steinmeier, and Tabatabai, "How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009," *Michigan Retirement Research Center Working Paper 2009-206* (October 2009), available at www.mrrc.isr.umich.edu/publications/papers/pdf/wp206.pdf.

- Assets specifically earmarked for retirement have increased significantly over time. Adjusted for inflation and population growth, retirement assets were nearly seven times the level at year-end 2013 than at year-end 1975.¹⁰

These statistics speak to the impact of the combined changes implemented over many years, with the increased generosity of Social Security benefits, the enactment of ERISA in 1974, the creation of the 401(k) plan in 1978,¹¹ EGTRRA in 2001, PPA in 2006, and other measures. A crucial foundation of this success is the voluntary employer-sponsored retirement plan system, built around the laws and regulations that allow deferral of tax on compensation set aside for retirement. Rules allowing tax-deferred compensation date back to the origin of the income tax,¹² and play a crucial role in encouraging employers to establish and maintain retirement plans for their workers. While it is important to consider how the retirement system can be improved still further, Congress should *not* throw out decades of progress by taking away the ability of American workers to make full use of the retirement vehicles they value so highly.

II. THE COMPOSITION OF RESOURCES RELIED UPON IN RETIREMENT DIFFERS FROM HOUSEHOLD TO HOUSEHOLD

Assessing whether or not workers are saving enough for retirement requires a standard by which to judge savings adequacy. Retirement savings adequacy is typically defined as a relative, rather than an absolute, standard: savings would be judged to be adequate if the savings allowed retired households to maintain the standard of living they enjoyed while working. Another complicating factor in judging adequacy is that the focus on dedicated retirement savings typically occurs later in a working career. Younger households typically have other savings goals that compete with retirement savings, such as funding education, purchasing a home, and building a rainy-day fund. Importantly, this life-cycle pattern of savings observed in the data is consistent with rational economic behavior. Because of this change in focus over the life cycle, it is difficult to assess retirement preparedness for households that are not in or near retirement.

In assessing whether American workers are saving enough for retirement, it is also important to understand the different resources that most people will draw from in retirement and the role that each resource plays. The traditional analogy is that retirement resources are like a three-legged stool. This analogy implies that everyone should have resources divided equally among Social Security, employer-sponsored pension plans, and private savings. This is not, nor has it ever been, an accurate picture of

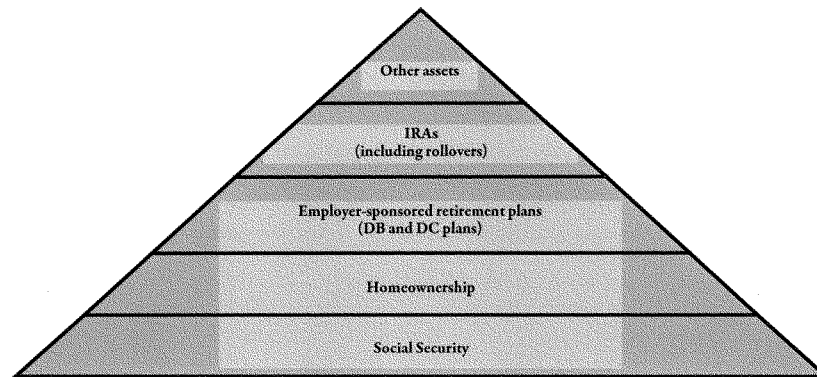
¹⁰ See Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 4, p. 11 (updated to year-end 2013).

¹¹ Although Congress added section 401(k) to the Internal Revenue Code with the Revenue Act of 1978, it was not until November 10, 1981 that the Internal Revenue Service (IRS) formally described the rules for these plans. See discussion pp. 1–4 in Holden, Brady, and Hadley, “401(k) Plans: A 25-Year Retrospective,” *Investment Company Institute Research Perspective* 12, no. 2 (November 2006), available at www.ici.org/pdf/per12-02.pdf.

¹² The modern federal income tax was established in 1913. The deferral of tax on contributions to profit-sharing plans was codified in the Revenue Act of 1921, and deferral of tax on contributions to DB plans was added in the Revenue Act of 1926. The earlier statutory text is vague as to what forms of compensation represent current income, so it is not clear how deferred compensation was treated before these laws were enacted.

Americans' retirement resources. A pyramid is a better representation of retirement resources (*see* figure below). The retirement resource pyramid has five basic components: Social Security; homeownership; employer-sponsored retirement plans (both private-sector employer and government employer plans, as well as both DB and DC plans); IRAs (including rollovers); and other assets.¹³ The composition of the retirement resource pyramid—that is, the extent to which a household relies on any given resource—will differ from household to household.

Retirement Resource Pyramid



Source: Investment Company Institute; *see* Brady, Burham, and Holden, *The Success of the U.S. Retirement System* (December 2012)

It is possible to estimate the retirement resource pyramid for U.S. households, but doing so requires measuring the value of a household's future stream of Social Security and DB plan benefits. Gustman, Steinmeier, and Tabatabai (2009) undertook this exercise using data from the Health and Retirement Study (HRS).¹⁴ The analysis focuses on households approaching retirement—in this case, households with a member born between 1948 and 1953 (aged 57 to 62 in 2010). Their analysis is used

¹³ These assets can be financial assets—including bank deposits and stocks, bonds, and mutual funds owned outside of employer-sponsored retirement plans and IRAs—and nonfinancial assets—including business equity, nonresidential property, second homes, vehicles, and consumer durables (long-lived goods such as household appliances and furniture). Assets in this category tend to be owned more frequently by higher-income households. For a more complete discussion of the retirement resource pyramid, *see* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012).

¹⁴ *See* Gustman, Steinmeier, and Tabatabai, "How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009," *University of Michigan Retirement Research Center Working Paper 2009-206* (October 2009). The paper used 2006 HRS data, and the authors provided updated data from the 2010 HRS, which are presented in the figure.

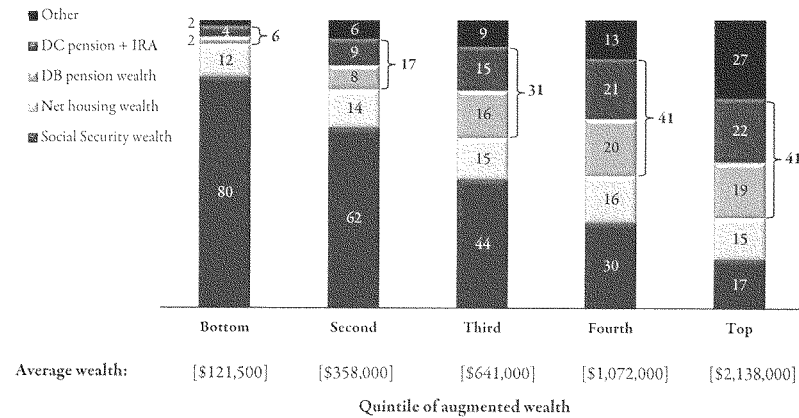
to estimate the components of the retirement resource pyramid for these households, with households grouped by their augmented wealth (*see figure below*). Reflecting the progressive benefit formula, households approaching retirement in the lowest augmented wealth quintile (the lowest 20 percent of households approaching retirement ranked by augmented wealth) rely heavily on Social Security benefits. In 2010, Social Security comprised 80 percent of total augmented wealth for households approaching retirement who were in the lowest augmented wealth quintile. Although Social Security typically replaces a high percentage of earnings for these households, many also had equity in their homes, accumulated retirement benefits, and other assets.

In comparison with those with lower augmented wealth, households approaching retirement in the middle of the augmented wealth distribution rely more heavily on resources other than Social Security. Social Security comprised a large portion of total augmented wealth (44 percent) for households approaching retirement in the middle of the augmented wealth distribution (*see figure below*). For this group, equity in their homes made up 15 percent of augmented wealth and the combination of employer-sponsored DB and DC retirement plans and IRAs comprised another 31 percent of augmented wealth. These households in the middle of the augmented wealth distribution are reliant on a mix of resources in retirement: some from Social Security, but more than half from employer-sponsored retirement plans and IRAs, equity in their homes, and other assets.

The highest augmented wealth quintile of households approaching retirement relies relatively little on Social Security, reflecting the fact that Social Security benefits typically replace a much smaller share of lifetime earnings for this group. For these households, employer-sponsored retirement plans, IRAs, and other assets are more important. For households approaching retirement in the top augmented wealth quintile, Social Security comprised only 17 percent of total augmented wealth (*see figure below*). For this group, 22 percent of total augmented wealth was composed of employer-sponsored DC plans and IRAs, 19 percent from DB plans, 15 percent from equity in their homes, and 27 percent from other assets.

Retirement Resource Pyramid Varies with Wealth

Percentage of wealth by wealth quintile, households with at least one member age 57 to 62, excludes top and bottom one percent, 2010



Source: Investment Company Institute tabulation derived from an updated Table 3 of Gustman, Steinmeier, and Tabatabai (2009) using Health and Retirement Study (HRS) data

A. Social Security

Although often ignored in retirement policy discussions, the United States already has a mandatory retirement plan: Social Security. Social Security stands at the base of the retirement resource pyramid, providing households across all levels of earnings with inflation-indexed income for life. For most households, Social Security is one of their most valuable resources.

When Social Security was signed into law in 1935, it was intended to replace a modest portion of income. Changes to the system since its inception—in particular, two periods of expansion, first in the 1950s and then again in the 1970s—increased benefits substantially, especially for those with low lifetime earnings.¹⁵ Described as a “cornerstone” for U.S. retirement security at its beginning, Social Security has transformed into a comprehensive government-provided pension for workers with lower lifetime earnings and a strong foundation for retirement security for those with higher lifetime earnings.

The expansion of benefits has not come without costs. In 1937, the OASDI tax rate was 2.0 percent on up to \$3,000 of wages and salary (equivalent to about \$49,000 in constant 2014 dollars).

¹⁵ See Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), pp. 17–20.

Today, Social Security mandates contributions for American workers of 12.4 percent of wages and salary from the first dollar they earn up to the maximum annual earnings covered by the system, *i.e.*, \$117,000 in 2014.¹⁶

Social Security benefits are designed to be progressive; that is, the benefits represent a higher proportion of pre-retirement earnings for workers with lower lifetime earnings than for workers with higher lifetime earnings. For example, for the cohort of individuals born in the 1940s, Congressional Budget Office (CBO) analysis shows that Social Security benefits are projected to replace 77 percent of average indexed earnings for the typical individual in the bottom 20 percent of individuals ranked by lifetime earnings.¹⁷ The replacement rate drops to 51 percent for the second quintile, and then declines more slowly as lifetime earnings increase. Social Security benefits are projected to replace a considerable fraction of indexed earnings—32 percent—for even the top 20 percent of earners.

These statistics, however, understate the generosity of Social Security benefits, as illustrated in a recent paper by Pang and Schieber.¹⁸ The replacement rate measures used by both the CBO and the Social Security Administration (SSA) measure Social Security benefits as a percentage of wage-indexed earnings. If a worker is seeking to maintain their standard of living in retirement, inflation-indexed, not wage-indexed, earnings represent a better metric of success. Because wages have grown more quickly than inflation over time, Social Security benefits replace a higher percentage of inflation-indexed earnings. To illustrate the impact, Pang and Schieber calculate replacement rates for workers born in 1949 and retiring at age 65 in 2014.¹⁹ Measured as a percentage of wage-indexed earnings, Social Security benefit replacement rates are 77 percent for very low earners, 42 percent for medium earners, and 28 percent for maximum earners (*see figure below*). Using inflation-indexed earnings, the replacement rates are 87 percent, 47 percent, and 31 percent, respectively.

¹⁶ See Social Security Administration, "Contribution and Benefit Base Determination," available at www.ssa.gov/oact/cola/cbbdet.html. For historical tax rates, *see* www.ssa.gov/oact/progdata/taxRates.html. For the historical earnings base, *see* www.ssa.gov/oact/cola/cbb.html. OASDI taxes as a percentage of earnings increased to 3.0 percent by 1950, to 6.0 percent by 1960, to 8.4 percent by 1970, to 10.16 percent by 1980, and reached the current 12.4 percent rate in 1990.

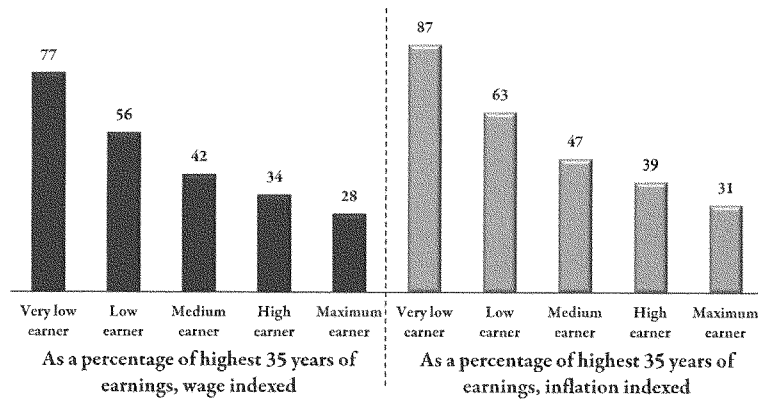
¹⁷ See Congressional Budget Office, *The 2013 Long-Term Projections for Social Security: Additional Information* (October 2013), available at www.cbo.gov/publication/44972. These are an update of the estimates in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), Figure 9, p. 19. *See also* Investment Company Institute, *2014 Investment Company Fact Book*, available at www.icifactbook.org.

¹⁸ See Exhibit 3 in Pang and Schieber, "Why American Workers' Retirement Income Security Prospects Look so Bleak: A Review of Recent Assessments," *Working Paper* (May 31, 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2433123.

¹⁹ *Ibid.* The authors used wage profiles developed by SSA for five hypothetical workers with different levels of lifetime earnings.

Social Security Benefits Are More Generous to Workers with Low Lifetime Earnings

Alternative replacement rates for estimated Social Security benefits for SSA hypothetical workers born in 1949, retiring at age 65 in 2014



Source: Pang and Schieber (2014)

Because of the progressive benefit formula, Social Security benefits comprise a higher share of lower-earning households' retirement income. In addition, although this resource typically is not included in measures of household wealth, if it were to be counted as an asset, the value of future Social Security benefits would comprise a higher share of assets in such an augmented balance sheet for those households (as discussed above). In contrast, to maintain their standard of living in retirement, higher-earning households have a greater need to supplement Social Security benefits.

B. Homeownership

A second resource available to the vast majority of retired households is the home in which they live.²⁰ Homeownership increases with age and is high across all income groups among near-retiree households. Households who own homes often have no or low mortgage debt by the time they reach retirement age. Households do not have to sell their homes to benefit from them in retirement; they simply have to live in them. Homeownership is like having an annuity that provides rent, as the home provides a place to live that otherwise would have to be rented.

²⁰ See Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), pp. 22–26.

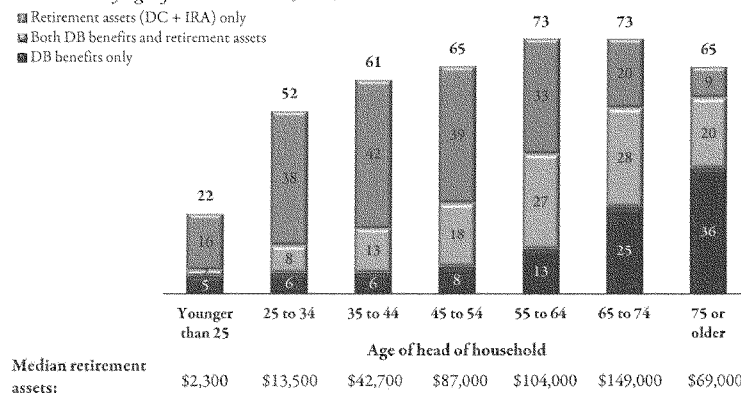
C. Employer-Sponsored Retirement Plans and IRAs

The next two layers of the retirement resource pyramid consist of accumulations in employer-sponsored retirement plans (both private-sector employer and government employer plans, as well as both DB and DC plans) and IRAs (both contributory and those resulting from rollovers from employer-sponsored plans). Near-retiree households across all income groups have these retirement benefits, but employer-sponsored retirement plans and IRAs typically provide a larger share of resources for higher-income households, for whom Social Security benefits provide a smaller share.

The share of households with retirement accumulations—that is, with benefits accrued in a DB plan or assets in a DC plan or IRA—follows a life-cycle pattern. Based on data from the 2013 Survey of Consumer Finances (SCF), conducted by the U.S. Federal Reserve Board, the share of households with retirement accumulations increases from 22 percent of households younger than 25, to 61 percent of households aged 35 to 44, to 73 percent of households aged 65 to 74 (*see figure below*). Similarly, among those with a DC plan or IRA, median retirement assets increase from \$2,300 for households younger than 25, to \$42,700 for households aged 35 to 44, to \$149,000 for households aged 65 to 74.

Share of Households with DB, DC, or IRA Increases with Age, as Do Retirement Assets

Households by age of household head, 2013



Note: Retirement assets include DC plan assets and IRAs. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits. Components may not add to the total because of rounding.

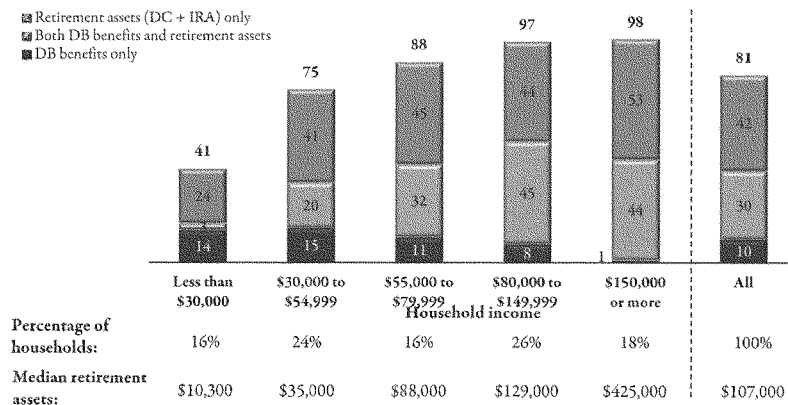
Source: ICI tabulations of the Survey of Consumer Finances

The figure above analyzed the incidence of retirement accumulations by age of household across all households to highlight the life-cycle pattern of focus on saving for retirement. The next figure looks more closely at households who are still working and are getting close to retirement. Focusing on these near-retiree households—that is, working households aged 55 to 64—81 percent have retirement

accumulations and, among those with DC plans or IRAs, median retirement assets are \$107,000 (*see* figure below). Pre-retirees across all income groups have retirement accumulations, including 41 percent of near-retiree households with income less than \$30,000 and 75 percent of near-retiree households with income of \$30,000 to \$54,999. For the top 60 percent of households by income, over 90 percent have retirement accumulations.

Near-Retiree Households Across All Income Groups Have Retirement Assets, DB Plan Benefits, or Both

Households with working head aged 55 to 64, by household income, 2013



Note: Near-retiree households are households with a working head aged 55 to 64 in 2013, excluding the top and bottom 1 percent of the income distribution. Retirement assets include DC plan assets and IRAs. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits. Components may not add to the total because of rounding.

Source: ICI tabulations of the Survey of Consumer Finances

As with Social Security benefits, assets specifically earmarked for retirement have increased significantly over time. In 1975, aggregate retirement assets, including assets in DB plans, represented about \$27,700 per household in constant 2013 dollars. By year-end 2013, that figure stood at about \$185,700—6.7 times the level in 1975.²¹

²¹ See Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), Figure 4, p. 11 (updated to year-end 2013).

III. EFFECTIVE POLICYMAKING REQUIRES A BETTER UNDERSTANDING OF THE “COVERAGE GAP”

While the current retirement laws and policies are working well and are helping tens of millions of American workers accumulate savings and generate retirement income, some argue that the system is a failure in that not all Americans have access to an employer-sponsored retirement plan. This perceived failure is referred to as the so-called “coverage gap.” The fact is that the majority of private-sector workers needing and demanding access to pensions as part of their compensation have pension plan coverage.²² Discussions about coverage, however, often rely on misleading or incomplete coverage statistics. Household surveys, such as the Current Population Survey (CPS), typically show lower rates of pension coverage than surveys of business establishments, such as the National Compensation Survey (NCS). For example, the CPS data show that 57 percent of all full-time private-sector wage and salary workers had pension coverage in 2012.²³ The March 2014 NCS, on the other hand, shows that 65 percent of all private-industry workers and 74 percent of all full-time private-industry workers have access to a pension.²⁴

Even if one uses the CPS data for analysis, however, looking below the aggregate statistics paints a significantly different picture. Of the 80.6 million workers who report that their employer does not sponsor a pension plan in 2012, 18.2 million are either federal workers, state and local workers, self-employed, or work without pay.²⁵ This leaves 62.5 million private-sector wage and salary employees who report that their employer does not sponsor a retirement plan. Yet this still overstates the number on which to focus. Of these, 6.1 million are under 21 and 3.3 million are aged 65 or older. This leaves 53.1 million private-sector wage and salary employees aged 21 to 64 who report that their employer does not

²² See Brady and Bogdan, “Who Gets Retirement Plans and Why, 2012,” *ICI Research Perspective* 19, no. 6 (October 2013), available at www.ici.org/pdf/per19-06.pdf. Current Population Survey (CPS) data for 2012 indicate that 50 percent of private-sector wage and salary workers were employed by firms that sponsored retirement plans (including both DB and DC plans). However, access to retirement plans is not random. Limiting the analysis to full-time, full-year workers aged 30 to 64, access to retirement plans increases to 60 percent. If the analysis is narrowed further to the groups of workers most likely to be focused on saving for retirement—workers aged 30 or older with at least moderate levels of earnings and all but the lowest earning workers aged 45 or older—then 69 percent work for employers that sponsor retirement plans. In addition, some in this group without access to plans at their own employers have access to plans through their spouses’ employers. Taking into account access through spouses, 74 percent of workers who are likely to be focused on saving for retirement have access to employer-provided retirement plans, and 93 percent participate in the plans offered.

²³ *Ibid* (Figure 3). Pension coverage includes DB and/or DC plans.

²⁴ See Table 1 in U.S. Department of Labor, Bureau of Labor Statistics, “Employee Benefits in the United States – March 2014,” News Release USDL-14-1348 (July 25, 2014), available at www.bls.gov/news.release/pdf/ebs2.pdf. Pension coverage includes DB and/or DC plans.

²⁵ This includes 1.0 million federal government workers and 4.2 million state and local government workers who reported that their employers did not sponsor retirement plans (and possibly gave an inaccurate response to the survey). Another 13.0 million workers without an employer-sponsored retirement plan were self-employed and approximately 149,000 reported that they worked without compensation of any type. Self-employed workers are excluded because, being their own employer, they can access an employer-provided plan by exercising their option to establish a plan. See Figure 5 in Brady and Bogdan, “Who Gets Retirement Plans and Why, 2012,” *ICI Research Perspective* 19, no. 6 (October 2013).

sponsor a pension plan.²⁶ Of these, 21.7 million are part-time, part-year workers²⁷ and 7.6 million are full-time, full-year workers aged 21 to 29 (*see figure below*).²⁸ This leaves 23.8 million full-time, full-year private-sector wage and salary workers aged 30 to 64 who report that their employer does not sponsor a pension plan. Of these, 7.6 million earn less than \$26,000 a year²⁹ and 3.8 million earn \$26,000 to \$44,999 a year and are aged 30 to 44.³⁰ The result is 12.4 million private-sector wage and salary employees who are likely to desire to save for retirement in the current year and who do not have access to an employer plan. But 2.2 million of these have a spouse whose employer sponsors a plan. The final result is 10.2 million private-sector wage and salary employees who are likely to desire to save for retirement in the current year and who do not have access to an employer plan through their own employer or a spouse.

²⁶ *Ibid* (Figure 5).

²⁷ Most part-time, part-year workers have low income and high replacement rates from Social Security. They are unlikely to save for retirement in the current year if they work full-time or year-round in other years. *Ibid* (Figure 6).

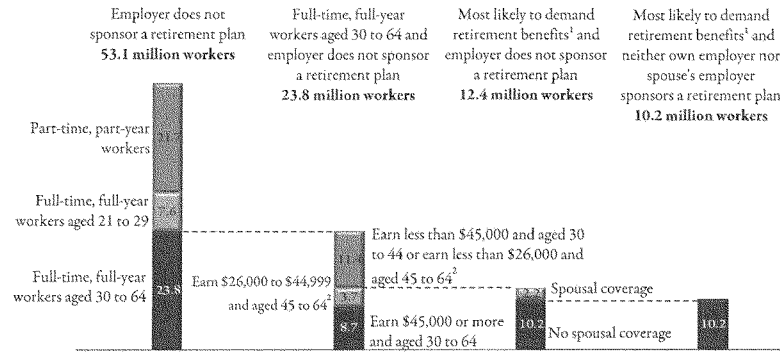
²⁸ Few in this age group save primarily for retirement. Workers age 21 to 29 save primarily for education, the purchase of a home, or for precautionary reasons. *Ibid* (*see* ICI tabulations from the 2010 Survey of Consumer Finances, Figure 1, p. 4).

²⁹ The primary concern for workers earning less than \$26,000 per year is they do not have enough to spend on food, clothing and shelter. In fact, many are eligible for government income assistance so that they will be able to spend more than what they earn on these items. If these workers consistently have low earnings throughout their careers, Social Security will replace a high percentage of their lifetime earnings. *Ibid* (*see* Tables 41 and 42 in Brady and Bogdan "Supplemental Tables for Who Gets Retirement Plans and Why, 2012," available at www.ici.org/info/per19-06_data.xls).

³⁰ Workers age 30 to 44 who earn between \$26,000 and \$44,999 a year may have the ability to save, but have other saving priorities, such as starting a household and having children. Given that they get a substantial replacement rate from Social Security, they are likely to delay saving for retirement until later in life—perhaps after age 44. *Ibid* (Tables 41 and 42).

A Closer Look at Workers Who Are Not Covered by an Employer Plan

Millions of private-sector wage and salary workers aged 21 to 64, 2012



¹ Full-time, full-year workers who earn \$45,000 or more and are aged 30 to 64 or earn \$26,000 to \$44,999 and are aged 45 to 64.

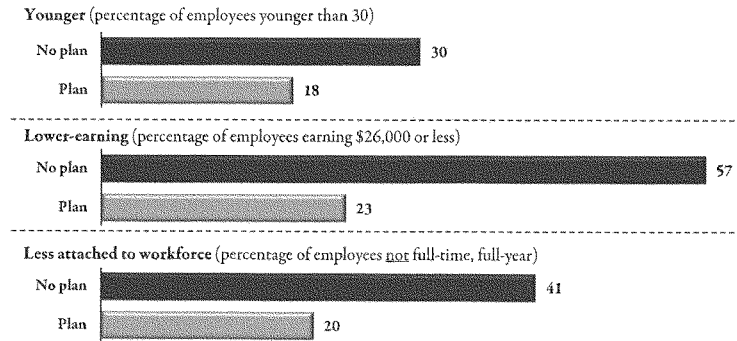
² Among full-time, full-year workers aged 35 to 44, \$26,000 represents the top earnings of the 20th percentile of annual earnings and \$45,000 represents the top earnings for the 50th percentile of annual earnings.

Note: Components may not add to the total because of rounding.

Source: Investment Company Institute tabulations of March 2013 Current Population Survey; see Brady and Bogdan, "Who Gets Retirement Plan and Why, 2012," *ICI Research Perspective* 19, no. 6 (October 2013)

Access to retirement plans at work is not randomly distributed throughout the workforce. Differences in workforce composition appear to be a primary cause for the lower rate at which small employers sponsor retirement plans.³¹ As a group, the characteristics of small-firm employees differ substantially from the characteristics of large-firm employees. Nevertheless, workers at small firms that sponsor plans are very similar to workers at large firms that sponsor plans, and workers at small firms that do not sponsor plans are very similar to workers at large firms that do not sponsor plans. In particular, employees who work for firms that do not sponsor retirement plans are more likely to be younger, have lower earnings, and have less attachment to the workforce (*see figure below*). For example, among employers that do not sponsor retirement plans, 30 percent of their employees are younger than 30, 57 percent of their employees are low earners, and 41 percent of their employees are not full-time, full-year. In contrast, among employers that do sponsor retirement plans, only 18 percent of their employees are young, only 23 percent are low earners, and only 20 percent are not full-time, full-year.

³¹ See Brady and Bogdan, "Who Gets Retirement Plans and Why, 2012," *ICI Research Perspective* 19, no. 6 (October 2013).

Companies That Don't Offer Pension Plans Have Workforces That Are:


Source: Investment Company Institute tabulations of March 2013 Current Population Survey; see Brady and Bogdan, "Who Gets Retirement Plans and Why, 2012," *ICI Research Perspective* (October 2013)

It is also important to remember that households with earned income have access to IRAs to save for retirement on a tax-advantaged basis. For example, Congress designed the traditional IRA with two goals in mind: (1) to create a contributory retirement account for workers, and (2) to provide a rollover vehicle to preserve assets accumulated in employer-sponsored retirement plans (both DB and DC). Although a small share of individuals contributes to traditional IRAs in any given year,³² the majority of those who contribute make repeat contributions in succeeding years.³³ In addition, many of those IRA investors contributing to traditional IRAs contribute at the limit.³⁴

Many more workers will have access to an employer-sponsored retirement plan at some point during their working careers and will reach retirement with work-related retirement benefits than is implied by looking at a snapshot of coverage among all workers at any point in time. Data from the SCF show that accrued benefits and asset accumulations in employer-sponsored retirement plans and IRAs

³² A number of factors may account for this relatively low contribution rate. Two of the major determinants of individuals' decisions to contribute to traditional IRAs are their assessment of their need for additional retirement savings and their ability to deduct contributions from their taxable income. Individuals who are covered by retirement plans at work may find that they can meet their saving needs through those plans. In addition, coverage by such plans may curtail their eligibility to make tax-deductible contributions. For lower-income households, Social Security replaces a much higher fraction of pre-retirement earnings, which may reduce their need for additional retirement savings. Furthermore, there is some evidence that confusion about IRA rules may prevent some individuals from contributing. See Holden and Bass, "The IRA Investor Profile: Traditional IRA Investors' Activity, 2007–2012," *ICI Research Report* (March 2014), available at www.ici.org/pdf/rpr_14_ira_traditional.pdf.

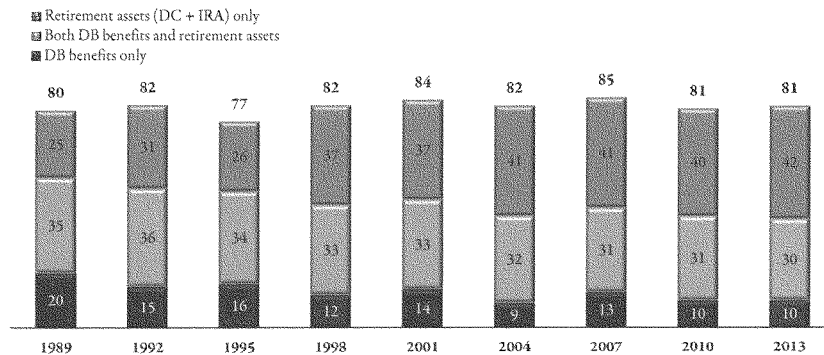
³³ *Ibid.*

³⁴ *Ibid.*

constituted a resource for about 80 percent of near-retiree households in 2013 (*see figure below*).³⁵ For the past two decades about 80 percent of near-retiree households—those with a working head of household aged 55 to 64 in the year indicated—have consistently accrued DB, DC, or both types of retirement plan benefit (from private-sector employer and government employer plans), or IRAs (rollover and contributory). Despite the fact that DC plans have grown relative to DB plans among private-sector employers, the portion of near-retiree households with retirement accumulations has remained stable. What has changed is the composition of those retirement accumulations: in 1989, 55 percent of near-retiree households had DB benefits and 60 percent had retirement assets (DC plans or IRAs, or both), compared with 2013, when 40 percent of near-retiree households had DB benefits and 72 percent had retirement assets.

Vast Majority of Near-Retiree Households Have Accrued Pension Benefits

Percentage of near-retiree households, 1989–2013



Note: Near-retiree households are households with a working head aged 55 to 64 in the year indicated, excluding the top and bottom 1 percent of the income distribution. Retirement assets include DC plan assets and IRAs. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits. Components may not add to the total because of rounding.

Source: Investment Company Institute tabulations of the 1989–2013 Survey of Consumer Finances

³⁵ Update of tabulations in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 13, p. 29.

IV. THE VOLUNTARY EMPLOYER-SPONSORED RETIREMENT SYSTEM IS CHARACTERIZED BY FLEXIBILITY, COMPETITION, AND INNOVATION

A strength of the voluntary employer-provided retirement system is the flexibility built into its design. This flexibility has allowed a tremendous amount of innovation to take place over the past few decades, due to the combined efforts of employers, employees, and plan service providers. Some of these innovations—for example, making contributions through regular payroll deduction, which provides convenience and stability, or employer matching contributions, designed to further incentivize employee participation—are now taken for granted as standard plan features. Another important improvement has been automatic enrollment to increase plan participation.³⁶ Another change, auto-escalation, gradually increases the share of pay contributed each pay period until it reaches a desired goal. Further, target date funds also have become increasingly popular both as a default and as an employee choice and have been successful in ensuring that investors have a diversified portfolio that rebalances to be more focused on income and less focused on growth over time.³⁷

It is important to remember that the employer-sponsored retirement system is premised on its voluntary and flexible nature; employers can choose to provide retirement plans to their employees tailored to their specific needs—but they are not required to do so. The current tax structure—including allowing the deferral of tax on compensation contributed to employer-sponsored retirement plans—provides a strong and effective incentive for individuals at all income levels to save for retirement and encourages employers to sponsor plans that provide significant benefits to American workers of all income levels. Untoward changes in the retirement tax incentives would require each employer to reevaluate and potentially redesign its retirement plan offerings and could prompt them to consider eliminating their plans entirely.

A. 401(k) Plan Assets Tend to Be Concentrated in Lower-Cost Mutual Funds

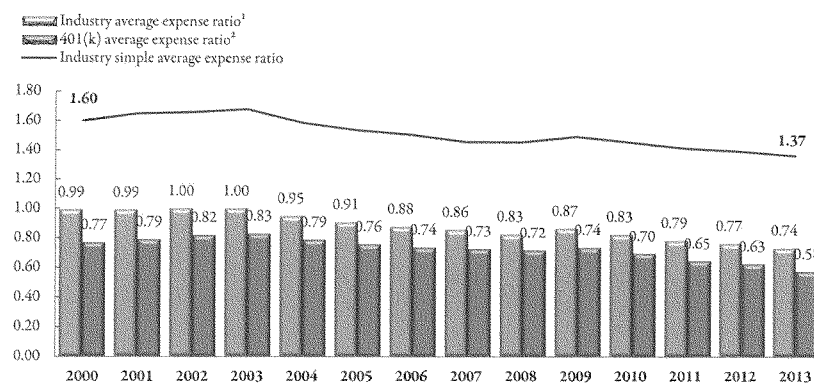
Employers design and offer 401(k) plans to attract and retain qualified workers, and financial companies compete to provide services to the plans. Competition and a growing asset base have contributed to the success of 401(k) plans by reducing investment costs, which results in cost-effective investing for 401(k) participants. In this respect, Institute research shows that the costs 401(k) plan participants have incurred for investing in long-term mutual funds have trended down over the past decade. For example, in 2000, 401(k) plan participants incurred expenses of 0.77 percent of the 401(k)

³⁶ The EBRI/ICI 401(k) Accumulation Projection Model demonstrates the increases in retirement income that can result from automatic enrollment. Replacement rates, modeled after adding automatic enrollment and investing contributions in a target date fund, increase significantly. See Holden and VanDerhei, “The Influence of Automatic-Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement,” *Investment Company Institute Perspective* 11, no. 2, and *EBRI Issue Brief*, no. 283 (July 2005), available at www.ici.org/pdf/per11-02.pdf and www.ebri.org/pdf/briefspdf/EBRI_IB_07-20054.pdf. Furthermore, studies find that adopting an automatic enrollment feature has a particularly strong impact on improving participation rates among low-income and younger workers. See, e.g., Utkus and Young, *How America Saves, 2014: A report on Vanguard 2013 defined contribution plan data*, Vanguard Center for Retirement Research (2014), available at <https://institutional.vanguard.com/iam/pdf/HAS14.pdf>.

³⁷ See Charlson, “Diversification Pays Off for Target-Date Funds,” *Morningstar Advisor* (January 17, 2013).

assets they held in equity funds (*see figure below*).³⁸ By 2013, that had fallen to 0.58 percent, a 25 percent decline.³⁹ The expenses 401(k) plan participants incurred for investing in hybrid and bond funds also fell from 2000 to 2013, by 19 percent and 21 percent, respectively.⁴⁰ It is also significant that participants in 401(k) plans tend to pay lower fees than fund investors overall. The 0.58 percent paid by 401(k) investors in equity funds is lower than the expenses paid by all equity fund investors (0.74 percent) and less than half the simple average expense ratio on equity funds offered for sale in the United States (1.37 percent). The experience of hybrid and bond fund investors is similar.

401(k) Mutual Fund Investors Concentrate Their Assets in Lower-Cost Equity Funds
Percent, 2000–2013



¹The industry average expense ratio is measured as an asset-weighted average.

²The 401(k) average expense ratio is measured as a 401(k) asset-weighted average.

Note: Data exclude mutual funds available as investment choices in variable annuities.

Sources: Investment Company Institute and Lipper; *see* Collins, Holden, Chism, and Duvall, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2013," *ICI Research Perspective* (July 2014)

B. American Workers Show Strong Support for the Defined Contribution Retirement Plan System

Given this progress in building nest eggs for American workers, it is no surprise that Americans highly value their DC plans and the features typically associated with them. A fall 2013 household

³⁸ *See* Collins, Holden, Chism, and Duvall, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2013," *ICI Research Perspective* 20, no. 3 (July 2014), available at www.ici.org/pdf/per20-03.pdf.

³⁹ *Ibid* (Figure 6, p. 12).

⁴⁰ *Ibid* (Figure 6, p. 12).

survey demonstrated American households' strong support for key features of DC plans, including DC plans' tax benefit, and their appreciation for the investment opportunity these plans provide.⁴¹

- **Americans overwhelmingly support preserving the tax incentives for retirement saving.** Eighty-six percent of all U.S. households disagreed when asked whether the tax advantages of DC accounts should be eliminated. Eighty-three percent opposed any reduction in employee contribution limits.⁴²
- **Vast majorities of American households oppose altering key features of DC plans.** Eighty-six percent of all U.S. households disagreed with the idea that individuals should not be permitted to make investment decisions in their DC accounts.⁴³
- **Investors like choice and control of investments.** Ninety-six percent of all DC account-owning households agreed that it was important to have choice in, and control of, the investment options in their DC plans. Eighty-six percent said their plan offers a good lineup of investment options.⁴⁴
- **Most households have positive attitudes toward the 401(k) system.** Sixty-six percent of all U.S. households surveyed in fall 2013 had favorable impressions of 401(k) and similar plan accounts, similar to the support shown in surveys taken in the prior four years.⁴⁵ More than three-quarters of households expressed confidence that DC plan accounts could help participants reach their retirement goals.⁴⁶

ICI's household surveys during the past five years find that despite the experience of a recent bear market and a broad economic downturn, Americans remain committed to saving for retirement and value the characteristics, such as the tax benefits and individual choice and control that come with DC plans.

V. TAX-DEFERRED COMPENSATION IS NOT TAX-FREE COMPENSATION

Discussion and policy proposals surrounding tax incentives for retirement often proceed from premise that compensation that is saved for retirement is similar to an exclusion or deduction, or in other words "tax-free." That premise is false. The tax code allows workers to *defer* taxation on compensation that is set aside for retirement in a qualified employer plan or in an IRA. With a deferral, taxes are collected in the year the worker receives the compensation (through a plan distribution or an

⁴¹ See Burham, Bogdan, and Schrass, "Americans' Views on Defined Contribution Saving," *ICI Research Report* (January 2014), available at www.ici.org/pdf/ppr_14_dc_plan_saving.pdf. The survey included 3,021 U.S. adults interviewed in November 2013 and December 2013. Survey results were weighted to be representative of U.S. households.

⁴² *Ibid* (Figure 3, p. 9).

⁴³ *Ibid* (Figure 3, p. 9).

⁴⁴ *Ibid* (Figure 2, p.7).

⁴⁵ *Ibid* (Figure 1, p. 5).

⁴⁶ *Ibid* (Figure 5, p. 13).

IRA withdrawal), rather than in the year the compensation is earned. When a distribution is taken, taxes are paid on both the original deferred compensation and the earnings on those deferrals from the plan or IRA.

A deferral of tax is *neither* a tax deduction *nor* a tax exclusion. Tax deductions (such as the deduction of mortgage interest expense) and tax exclusions (such as the exclusion of employer-paid health insurance premiums from taxable compensation) reduce taxes paid in the year taken, but do not affect taxes in any future year. In contrast, setting aside a portion of compensation until retirement reduces taxes paid in the year the compensation is earned, but *increases* taxes paid in the year the compensation is received.

The simple calculations used to quantify the tax benefits and revenue costs of tax exclusions and tax deductions accordingly do not apply to tax deferrals. Unlike a deduction or an exclusion, the benefits an individual receives from deferring tax on compensation cannot be calculated by simply multiplying the amount of compensation deferred by the individual's marginal tax rate. This is because the tax benefit is not the up-front deduction.⁴⁷

Instead, the benefits of deferral depend on many factors, with the most important factor being the length of time a contribution remains invested (which in turn is generally driven by the saver's age at the time of the contribution). The dollar value of the tax benefit also will depend on an individual's marginal tax rate, but that relationship is complex. In fact, under current law, controlling for the length of deferral, there already is little difference in the dollar value of the tax benefit generated by a \$1,000 retirement contribution among individuals in the top five federal income tax brackets (with marginal tax rates of 25, 28, 33, 35, and 39.6 percent).⁴⁸

A. Proposals to Limit the Up-Front Benefit of Tax Deferral Are Misguided

Because a *tax deferral* is neither a *tax deduction* nor a *tax exclusion*, it should not be included in proposals that limit the tax benefit of deductions and exclusions. In particular, because the tax benefit of a deferral is not the up-front tax savings, proposals that limit the up-front tax savings change the tax treatment substantially. Capping the up-front tax savings on retirement contributions would arbitrarily penalize workers, substantially reducing the tax benefits for those closest to retirement.

⁴⁷ As a rough approximation, the benefits of tax deferral are equivalent to facing a zero rate of tax on investment income. In the absence of deferral, an individual saving for retirement would first pay tax on her compensation, contribute the after-tax amount to a taxable investment account, and then pay taxes on investment returns each year. Other than tax on unrealized capital gains, no tax would be paid when account balances were withdrawn. Tax deferral changes the tax treatment at three different points in time: no tax is paid up front; no tax is paid on investment returns during the deferral period; and both contributions and investment returns are taxed upon withdrawal. If there is no change in an individual's marginal tax rate, the tax paid upon distribution pays back to the government, with interest, the up-front reduction in taxes. The remaining difference represents the tax benefit of deferral: tax-free investment income on the portion of the initial contributions that would have been contributed to a taxable account. See Brady, *The Tax Benefits and Revenue Costs of Tax Deferral*, Investment Company Institute (September 2012), available at: www.ici.org/pdf/ppr_12_tax_benefits.pdf.

⁴⁸ *Ibid.*

Several proposals intended to limit the up-front benefit of tax-deferred retirement plan contributions have been introduced in recent years. Since fiscal year 2011 (FY2011), the Administration's budget has included a proposal to "cap" the benefits of itemized deductions at 28 percent. Starting with the FY2013 budget, the proposal was expanded so that the 28 percent cap also applied to tax-deferred employee contributions to DC plans and tax-deferred IRA contributions. In his tax reform discussion draft, Ways and Means Committee Chairman Camp (R-MI) included a proposal that would subject tax-deferred employee and employer contributions to DC plans to a 10 percent surtax. Although the 10 percent surtax proposal appears to be much different from the 28 percent cap proposal, the combination of the surtax with a top marginal rate of 25 percent is equivalent to having a top marginal rate of 35 percent and a 25 percent cap. Both the 28 percent cap proposal and the 10 percent surtax proposal are variants of proposals that have been around for some time: turning all deductions and exclusions into flat-rate credits. For example, in 2006, Batchelder, Goldberg, and Orszag proposed to turn all "tax incentives" into refundable 15 percent credits.⁴⁹ More recently, Gale, John, and Smith released a similar proposal specifically for retirement contributions.⁵⁰

The idea of limiting the tax benefits of deductions and exclusions, rather than eliminating them altogether, may seem at first glance to be a modest proposal. Under current tax law, a deduction or exclusion generally reduces a taxpayer's income tax by the amount of the item multiplied by the taxpayer's marginal tax rate. For example, an additional \$1,000 of mortgage interest deduction would reduce income taxes by \$350 for a taxpayer in the 35 percent tax bracket, and by \$250 for taxpayer in the 25 percent tax bracket. Under both the Administration's 28 percent cap proposal and the Camp 10 percent surtax proposal, the tax benefit of the mortgage interest deduction would remain unchanged for the 25 percent marginal rate individual, but would be reduced to \$280 or \$250, respectively, for the 35 percent marginal rate individual.

When applied to tax deferrals, however, the impact of these proposals is anything but modest. These proposals would substantially change the tax treatment of retirement contributions. To implement a cap on the up-front benefit, taxpayers would pay an additional "cap tax" or "surtax" on retirement plan contributions. For example, a taxpayer in the 35 percent bracket would pay a tax on a \$1,000 contribution of \$70 (7 percent, or 35 percent less 28 percent) under the 28 percent cap proposal, a tax of \$100 with a 10 percent surtax, and a tax of \$200 (20 percent, or 35 percent less 15 percent) with a 15 percent credit. Taxes paid in retirement would remain unchanged, however, with all distributions from the account subject to tax.⁵¹ Thus, the up-front value of the tax deferral is reduced by the "surtax"

⁴⁹ See Batchelder, Goldberg, and Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," *New York University Law and Economics Working Papers*, Paper 77 (October 2006), available at lsr.nellco.org/nyu_lawp/77.

⁵⁰ See Gale, John, and Smith, "New Ways to Promote Retirement Saving," *AARP Public Policy Institute Research Report* no. 2012-09 (October 2012), available at www.aarp.org/contents/dam/aarp/research/public_policy_institute/econ_sec/2012/new-ways-promote-retirement-saving-AARP-pp-econ-sec.pdf.

⁵¹ This is the case with the 15 percent credit proposal, the Camp 10 percent surtax proposal, and the Administration's FY2013 28 percent cap proposal. Responding to criticism that workers could be made worse off by contributing to a retirement plan, the Administration's FY2014 proposal included a provision for an unspecified basis adjustment. Any basis adjustment that would ensure no worker is made worse off contributing to a retirement plan would be unintuitive, complex,

or “cap tax,” but the tax ultimately paid on income from the retirement account is not reduced. In effect, taxpayers would be taxed on contributions made to the retirement account and again as they receive the amounts in the form of distributions.

The additional “surtax” or “cap tax” would create a drag on a saver’s return, sharply reducing the benefits of tax deferral. In fact, some workers close to retirement age may find that they would have been better off paying taxes on the wages and investing in a taxable account.⁵² For example, a worker invested in stocks would need to hold the investment for 13 years before the benefits of deferral offset the impact of a 10 percent surtax.⁵³

Reducing the value of tax-deferred retirement contributions will reduce the incentives for employers to offer DC plans to their employees. Highly paid employees will no longer assign as much value to the opportunity to save in employer-sponsored plans. Some employers likely will find that the benefits their employees receive no longer justify the expense of offering a plan, and may choose to eliminate their plans and use the savings to simply increase cash compensation. It is difficult to predict the size of the effect, but if the 10 percent surtax or 28 percent cap were applied to tax-deferred retirement contributions, this change would undoubtedly reduce the number of employers that voluntarily sponsor a retirement plan.

B. Contribution Limits Already Are Low by Historical Standards

Several proposals have been made to reduce contribution limits to DC plans. The National Commission on Fiscal Responsibility and Reform’s so-called “20/20 proposal” suggested limiting the combination of employer and employee contributions to DC plans to the lesser of \$20,000 annually or 20 percent of compensation. Chairman Camp’s tax reform discussion draft would suspend inflation adjustments to DC plan contribution limits and DB plan benefit limits for 10 years.

Contribution limits are already low by historical standards.⁵⁴ As illustrated in the figure below, for 2014, the Internal Revenue Code Section 415(c) limit for total DC plan contributions (employer plus employee) is \$52,000. The original limit set under ERISA (\$25,000 in 1975; or about \$114,000 in today’s dollars) was indexed to inflation until 1983, when it was reduced to \$30,000 (or about \$71,000 in today’s dollars) and subsequently frozen. The Tax Reform Act of 1986 delayed reinstating inflation

burdensome on taxpayers, and difficult for the IRS to enforce. And, in the end, the benefits of tax deferral would still be reduced substantially.

⁵² See Brady, “A ‘Modest’ Proposal That Isn’t: Limiting the Up-Front Benefits of Retirement Contributions,” *ICI Viewpoints* (September 18, 2013), available at www.ici.org/viewpoints/view_13_limiting_upfront_benefits.

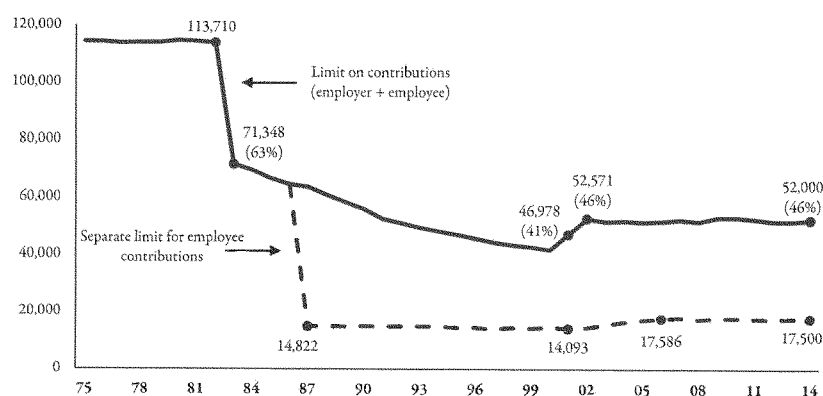
⁵³ This calculation assumes the up-front benefit is capped at 25 percent and the taxpayer is subject to a 35 percent marginal tax with no change in marginal tax rate over time and is not subject to penalty for early withdrawal. Investments are assumed to earn a 6.0 percent nominal rate of return composed of 3.0 percent long-term capital gains and dividend payments, 0.5 percent short-term capital gains, and 2.5 percent unrealized capital gains.

⁵⁴ For a discussion of the history of contribution limits, see pp.10–11 in Holden, Brady, and Hadley, “401(k) Plans: A 25-Year Retrospective,” *Investment Company Institute Research Perspective* 12, no. 2 (November 2006), available at www.ici.org/pdf/pcr12-02.pdf.

adjustment and implemented a \$5,000 “round-down” rule. The combined effect was the limit was unchanged until an inflation adjustment increased the limit to \$35,000 (or about \$47,000 in today’s dollars) in 2001. EGTRRA subsequently increased the limit to \$40,000 in 2002. The current limit, however, is less than half of the original limit in inflation-adjusted dollars. In addition, the Tax Reform Act of 1986 instituted a separate limit on employee contributions, whereas previous law only limited the combination of employer and employee contributions. EGTRRA increased the employee contribution limit in steps from 2002 to 2006, at which point the limit was indexed for inflation.

DC Plan Contribution Limits Are Low by Historical Standards

Limit on annual contributions to defined contribution plans, constant 2014 dollars, 1975–2014; percentage of ERISA limit, various years



Source: Investment Company Institute

Proposals to reduce those limits further would represent an unprecedented restriction on the ability of working individuals to defer a portion of their current compensation until retirement. Based on Congressional Budget Office (CBO) inflation assumptions, a 10-year freeze would effectively reduce contribution limits by about 20 percent. A \$20,000 limit would be below the original limit set in 1974 in *nominal* dollars.

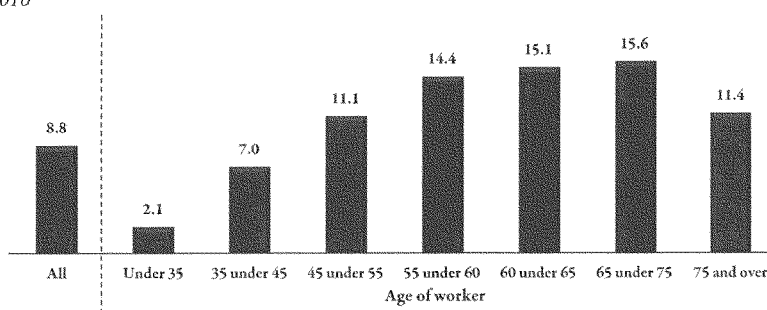
DC plan contribution limits are particularly important because of the uneven life-cycle pattern of retirement savings. The amount that workers contribute to their 401(k) plans is unlikely to be smooth and steady throughout their career. As a group, younger workers are less focused on retirement savings. They typically invest in other ways, such as funding education, purchasing a home, and raising children. Retirement savings typically ramps up as workers get older, both because earnings typically increase with age and because other expenses, such as childcare and education, decline.

The impact of the life-cycle pattern of retirement savings can be seen in statistics on workers who make the maximum allowable employee contribution to a DC plan.⁵⁵ Limit contributors typically are in their prime savings years and have moderate income: 69 percent of limit contributors were aged 45 to 64, and 58 percent had adjusted gross income (AGI) of less than \$200,000.⁵⁶

Although contribution limits may impact few workers in any given year, many more workers are affected at some point in their career. Only about 9 percent of workers with elective deferrals contributed the maximum allowed by law in 2010, but the share of workers at the limit increases with age (*see figure below*). For example, only about 2 percent of workers under 35 contribute at the limit, but that percentage increases to 15 percent for workers aged 60 to under 65.

Workers Are More Likely to Contribute at the Limit as They Approach Retirement

Percentage of W-2 workers with elective deferrals who contribute at the 402(g) elective deferral limit, by age, 2010



Source: Internal Revenue Service Statistics of Income Division

As with proposals to “cap” or apply a surtax to the tax benefit of employee contributions, freezing the employee and employer contribution limits or adopting the 20/20 proposal likely would cause some firms that previously offered retirement plans to terminate their plans. Employees affected by a lower effective contribution limit would face reductions in the tax benefits they receive. For some employers, the reduction in tax benefits received by their employees (including employees who currently have contributions in excess of proposed lower limits, or employees closer to retirement age who have

⁵⁵ The statistics used in this analysis are from IRS Statistics of Income Division (SOI) tabulations of Form W-2 data, available at www.irs.gov/uac/SOI-Tax-Stats-Individual-Information-Return-Form-W2-Statistics and described in Pierce and Gober, “Wage Income and Elective Retirement Contributions from Form W-2, 2008–2010,” *Statistics of Income Bulletin* (Summer 2013): pp. 5–21, Washington, DC: Internal Revenue Service Statistics of Income Division, available at www.irs.gov/pub/irs-soi/13insubulw2.pdf. The data are from the 2010 tax year, the most recent available. Limits are adjusted for catch-up contributions for workers age 50 or older. Some workers will be prevented from contributing the maximum allowed by law by rules established by their employer’s plan. These workers are not included in the statistics for limit contributors.

⁵⁶ *Ibid* (Table 2.F.3 and Table 2.G.3 in the data files).

anticipated the prospect of higher contributions later in their careers), would tip the balance, and these firms would decide to no longer offer a plan.

C. Tax Reform Should Not Favor DB Plans over DC Plans

Any comprehensive effort to address fiscal policy or tax reform should maintain one aspect of the current income tax: neutral tax treatment of qualified deferred compensation. Tax-deferred contributions to both DB plans and DC plans are treated equally under the tax code. Employees pay no tax on compensation contributed on their behalf to a qualified retirement plan, and no tax on the investment earnings of a plan while they accrue. Taxes are due only when employees take distributions from a plan. In addition, limits on DC plan contributions are intended to be roughly equivalent to the restrictions on the generosity of DB plans.

Many proposals focus on limiting the tax benefits of DC plans. For example, proposals to limit the up-front benefit of deferral only apply to DC plans. The Camp 10 percent surtax proposal would apply only to employee and employer DC plan contributions. The Administration's 28-percent proposal would apply only to employee elective deferrals to DC plans and tax-deferred IRA contributions. The 20/20 proposal would reduce the DC plan contribution limit, but leave the DB plan benefit limit unchanged. As a result the ratio of the DB benefit limit to the DC contribution limit would move from four to one to nearly ten to one.

Changing the rule only for DC plans means that benefits a worker gets from deferral will depend on how their employer structures their compensation. For example, consider the impact of the 20/20 proposal on two workers who both have an annual salary of \$100,000. The first is a private-sector worker who only has access to a DC plan. Under the proposal, the maximum amount of deferred compensation—that is, the combination of elective employee deferrals and employer contributions—would be \$20,000. The second is a federal government employee who is covered under the Federal Employee Retirement System (FERS). Under the proposal, this individual could contribute \$15,000 to the Thrift Savings Plan (TSP) and receive \$5,000 in employer contributions, for a total of \$20,000 in contributions. The federal government employee, however, would also be accruing DB pension benefits. For a worker approaching retirement, the additional DB benefit accrued in a year of work represents—depending on the length of service and other factors—an additional \$20,000 to \$50,000 in deferred compensation.

To maintain the neutrality of the current tax code, any changes to retirement plans should apply equally to DB plans and DC plans. In addition, any changes in the treatment of contributions should not single out employee versus employer contributions.

D. Limiting Accruals of Deferred Compensation Would Add Complexity, Could Cause Small Businesses to Terminate Plans

The Administration's FY2014 budget proposal to limit the total amount that an individual could accrue in retirement benefits would make the system more complex, place additional compliance burdens on individuals, and likely cause some employers—particularly small businesses—to terminate their retirement plans. Current law limits on the amount of tax-deferred compensation generally apply

to the benefits a worker receives from a single employer.⁵⁷ The proposal would place an additional limit on the total value of deferred compensation accumulated by any one individual—inclusive of accrued DB benefits, DC plan account balances, and IRAs.

Compliance with the new limit would require additional reporting from employer-sponsored plans to the IRS and place additional compliance burdens on individuals. Some employers, particularly small businesses, may choose no longer to offer a plan to their employees if the business owner or key employees can no longer accrue additional benefits. Such a change would also pose substantial difficulties for individuals as they plan for retirement or strategize about investing through their IRA. Imposition of such a proposal would therefore not only create significant administrative burdens, but would effectively penalize people for being diligent about their planning and saving and for accumulating retirement resources. This outcome is simply incongruent with the Committee's previous thinking and actions in the retirement policy sphere.

E. All Employees Will Be Hurt When Firms Drop Retirement Plans

The impact of the proposals which target DC plans would not be limited to taxpayers in the top three tax brackets (or taxpayers in Chairman Camp's proposed 35 percent tax bracket), or workers with contributions in excess of proposed lower limits. As discussed above, if these proposals are adopted, some firms that currently offer plans likely will decide to terminate their plans. With the loss of plans, lower-paid workers—who were never the intended target of the proposals—would lose the opportunity to save through an employer plan. While they receive substantial tax benefits from contributing, low- and moderate-income workers likely benefit as much or more from the non-tax features of employer-sponsored retirement plans. For example, these workers may value more highly the convenience of payroll deduction, the economies of scale that reduce the cost of investing, and the professional investment management offered through employer plans. There is also evidence that workers with moderate and high income are willing to accept lower cash wages in exchange for retirement benefits, whereas lower-income workers are not.⁵⁸ Thus, employer contributions are more likely to represent an increase in total compensation for lower-income workers, rather than a shift in the form of compensation. The loss of such contributions if employers drop their plans would be detrimental to the retirement security of lower-income workers.

F. Tax Deferral Equalizes the Incentive to Save

A criticism often leveled against tax deferral is that it provides an “upside-down” incentive to save. That is, it is argued that tax deferral results in higher-income workers having a larger incentive to save than lower-income workers.

⁵⁷ If an employer has multiple DB plans, the DB plan benefit limit would apply to all benefits accrued from the employer. Similarly, if an employer has multiple DC plans, the DC plan contribution limit would apply to all (employer and employee) contributions to plans sponsored by the employer. The lone exception to this rule is the limit on elective employee deferrals to 401(k)-type plans, which applies to the taxpayer rather than to the benefits received from a single employer.

⁵⁸ See Toder and Smith, “Do Low-Income Workers Benefit from 401(k) Plans?” *Center for Retirement Research Working Paper* no. 2011-14 (September 2011), available at: crr.bc.edu/wp-content/uploads/2011/10/wp_2011-14_508-1.pdf.

The incentive to save is the after-tax rate of return earned on investments. Normal income tax treatment discourages savings by reducing the after-tax rate of return. Because the tax on investment returns increases with income, the rate of return falls more for higher-income taxpayers.

Far from providing an “upside-down” incentive to save, tax deferral equalizes the incentive to save. The benefit of tax deferral is that it effectively taxes investment income at a zero rate.⁵⁹ By removing the difference between the market rate of return and the after-tax rates of return, tax deferral equalizes the incentive to save. That is, for any given investment, a dollar invested in a 401(k) plan will provide the same after-tax rate of return regardless of a worker’s tax bracket.

VI. CHANGES IN RETIREMENT POLICY SHOULD BUILD ON EXISTING SYSTEM—NOT PUT IT AT RISK

As the Committee on Finance considers possible changes to the U.S. retirement system, the Institute urges you to focus on the following policy objectives and improvements to ensure that as many American workers as possible are successful in retirement:

- **Continue to prioritize the goal of promoting retirement savings.** Promoting retirement savings must remain one of the nation’s top policy priorities.⁶⁰ We urge this Committee to continue its leadership in pursuing tax policies to improve our nation’s retirement system. As outlined above, the success of the current system has resulted in significant part from our existing and successful tax incentive structure, which works effectively to facilitate retirement plan savings by American workers and families. Even seemingly small changes that at first glance appear to affect only high-income individuals would, as detailed above, severely disrupt the success of the current system.
- **Recognize the significance of Social Security.** Social Security provides the foundation of retirement security for almost all American workers—and for the majority, it may be the largest single income source in retirement. Yet the Social Security system faces a projected long-term

⁵⁹ For an explanation of why this is the case, see discussion in Brady, *The Tax Benefits and Revenue Costs of Tax Deferral*, Investment Company Institute (September 2012), available at www.ici.org/pdf/ppr_12_tax_benefits.pdf; and Brady, “Retirement Plan Contributions Are Tax-Deferred—Not Tax-Free,” *ICI Viewpoints* (September 16, 2013), available at www.ici.org/viewpoints/view_13_deferral_explained. If a taxpayer’s marginal tax rates at the time of contribution and the time of distribution are the same, tax deferral is equivalent to taxing investment income at a zero rate. If tax rates are lower at the time of distribution, the benefits of tax deferral are increased. If tax rates are higher at the time of distribution, the benefits of tax deferral are reduced.

⁶⁰ A vast majority (79 percent) of U.S. households surveyed from November 2012 to January 2013 agreed that continuing retirement savings incentives should be a national priority. See Figure 12 in Holden and Bass, “America’s Commitment to Retirement Security: Investor Attitudes and Actions, 2013,” *ICI Research Report* (February 2013), available at www.ici.org/pdf/ppr_13_retir_sec_update.pdf.

imbalance.⁶¹ It is absolutely imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.⁶²

- **Foster innovation and growth in the voluntary retirement savings system.** Policymakers, plan sponsors, and service providers strive to improve the ability of American workers to make sound decisions about retirement savings and investing. Congress was instrumental in encouraging rules that improved disclosure of 401(k) plan fees and associated investment information. Now, we urge Congress to go further by promoting electronic delivery of plan information, interactive educational tools, and materials to help American workers understand their savings options. Employers should be encouraged to use automatic enrollment if appropriate for their employee base; employers may want to enroll their workers at higher levels of savings and escalate the savings more substantially than is perceived appropriate under current law. As noted above, studies show that automatic enrollment has a particularly notable impact on the participation rates of lower-income and younger workers because these groups are typically less likely to participate in a DC plan where affirmative elections are required.⁶³
- **Offer simpler plan features and easier access to multiple employer plans (“MEPs”) for small employers.** Small businesses often face particular challenges in establishing and maintaining retirement plans. Special attention should be given to addressing legal requirements that may create obstacles to plan sponsorship among smaller employers. Creating a new type of SIMPLE plan for small employers would encourage greater plan creation and coverage in smaller workplaces. The new plan would be modeled on existing SIMPLE plans, but would not require

⁶¹ For projections related to these programs, see The Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (July 2014), Washington, DC: U.S. Government Printing Office, available at www.ssa.gov/OACT/tr/2014/tr2014.pdf; The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2014 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (July 2014), Washington, DC: Centers for Medicare and Medicaid Services, available at www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2014.pdf; Congressional Budget Office, *The 2014 Long-Term Budget Outlook* (July 2014), available at www.cbo.gov/sites/default/files/cbofiles/attachments/45471-Long-TermBudgetOutlook_7-29.pdf; and Social Security Administration, “Detailed Reports on the Financial Outlook for Social Security’s Old-Age, Survivors, and Disability Insurance (OASDI) Trust Funds,” (2014), available at www.ssa.gov/OACT/tr/index.html.

⁶² Regardless of the form they take, changes to Social Security will likely increase the importance of employer-sponsored retirement plans and IRAs to provide for retirement adequacy. If Social Security benefits are cut, future retirees will need to accumulate more retirement resources. If taxes are raised on workers, net earnings will fall, but the amount of earnings that would need to be set aside to supplement Social Security benefits in retirement would remain largely unchanged. To the extent that either the benefit cuts or tax increases are structured to exempt workers with low lifetime earnings, it would place an even heavier burden on those already most dependent on employer-sponsored retirement plans and IRAs. For a discussion of how different methods of cutting Social Security benefits would impact workers with different levels of lifetime income, see Brady, “Measuring Retirement Resource Adequacy,” *Journal of Pension Economics and Finance* 9, no. 2 (April 2010): pp. 235–262.

⁶³ See note 36 and accompanying text, *supra*.

employer contributions. It would have contribution limits above traditional and Roth IRA limits, but below existing SIMPLE plan limits.⁶⁴ The Institute also supports easing restrictions on “open” MEPs, but targeting the provision to employers with fewer than 100 employees—the employer segment most in need of solutions to encourage retirement plan sponsorship.⁶⁵

- **Support flexible approaches to retirement saving and lifetime income.** Employers have a number of options for savings plans today,⁶⁶ but it is important for Congress to recognize that mandating a particular plan or contribution level would not work for workplaces where the majority of workers are focused on saving for goals other than retirement—such as education, a home, or an emergency fund.⁶⁷ The voluntary employer-provided retirement system recognizes that employers need the flexibility to design benefit packages that meet the unique needs of their particular workforce in the business’ specific competitive environment. This flexibility is also important in the context of proposals intended to assist plan participants and retirees in ensuring that they don’t run out of income in retirement or in determining how much retirement income they can generate from a 401(k), IRA, and other savings. All retirement income products and strategies involve tradeoffs and consideration of an individual’s personal circumstances, such as the amount of annuitized income to be received from Social Security,⁶⁸ other assets or income, health status and life expectancy, the need for emergency reserves, specific goals in retirement, and the need to provide for other family members. As a matter of public policy then, it is important to ensure a level playing field for all products and services.

* * *

The promotion of retirement savings—whether through employer-sponsored retirement plans or IRAs—has long been one of the Committee on Finance’s top priorities and legacies. In recent years, the Committee strengthened the private-sector retirement system by raising contribution limits in 2001

⁶⁴ We note that a conceptually similar provision, referred to as the “starter k” plan, has been proposed by Ranking Member Orrin Hatch (R-UT) in S. 1270, the “Secure Annuities for Employee (SAFE) Retirement Act of 2013.”

⁶⁵ For a discussion of how pension coverage varies by plan size, see Brady and Bogdan, “Who Gets Retirement Plans and Why, 2012,” *ICI Research Perspective* 19, no. 6 (October 2013).

⁶⁶ DC plans, traditional DB plans, hybrid plans, and SIMPLE IRAs all are available to meet the varying needs of employers.

⁶⁷ See Haveman, Holden, Wolfe, and Romanov, “The Sufficiency of Retirement Savings: Comparing Cohorts at the Time of Retirement,” *Redefining Retirement: How Will Boomers Fare?* Edited by Madrian, Mitchell, and Soldo: pp. 36–69, New York: Oxford University Press (2007); and Gustman, Steinmeier, and Tabatabai, “How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009,” *Michigan Retirement Research Center Working Paper* 2009-206 (October 2009), noting that households are more likely to focus on saving for retirement as they get older and as their income increases, and that younger and lower-income households, which are already contributing 12.4 percent of income to Social Security, tend to earmark the balance of their additional saving for liquidity, education, future large purchases, or to purchase homes.

⁶⁸ See discussion of Social Security replacement rates and how the role of Social Security varies by income and wealth on pages 9–11, *supra*.

(EGTRRA) and making those provisions permanent in 2006 (PPA). We welcome the Committee's continued leadership in pursuing policies to improve our nation's retirement system. But any changes should only build upon a successful system that tens of millions of U.S. households rely on to help them achieve retirement security. Consistent with the views of the overwhelming majority of Americans, we urge this Committee to preserve the current retirement savings tax incentives, including the compensation deferral rates without new caps or other limitations, and allow our successful employer-provided retirement system to flourish.

Statement of Ellen E. Schultz

Retirement Savings 2.0: Updating Savings Policy for the Modern Economy

Before the Committee on Finance U.S. Senate

September 16, 2014

Chairman Wyden, Ranking Member Hatch, Members of the Committee, thank you for inviting me.

As a journalist, I have closely followed retirement practices and policy since the later 1980s, for the most part as a reporter and editor at *The Wall Street Journal*. My work has been based largely on my analysis of regulatory filings, internal company memos, and documents that are rarely, if ever, examined by those evaluating the retirement system. And I speak today from that perspective.

You have asked me to comment on whether the tax breaks conferred on retirement plans—expenditures that will likely exceed \$100 billion in 2014 – are achieving what Congress intended. Namely, are these costly expenditures helping most working Americans accrue assets adequate to prevent them falling into poverty in their old age and becoming a burden to their families and society?

Based on what I have documented and reported over the past 25 years, that has not been the case. The economic benefits of the tax-subsidies that support the retirement system have flowed largely to the highest-paid Americans, to employers, and the financial services industry. The expenditures have done too little to improve the likelihood that most of working Americans will have adequate—or any—income (other than Social Security) when they can no longer work.

Keeping Defined Benefit Plans Effective

There is no question that defined benefit plans are generally preferable to 401(k) plans and have provided secure and adequate pension benefits to millions of people – and they have the potential of providing fair benefits across the board.

Policymakers recognize the value of what defined benefit plans do: Employees are automatically enrolled, professionals manage the investments, and the delayed compensation is ordinarily paid out in retirement as a lifetime annuity that the retiree and spouse cannot outlive.

But over the past two decades, I've seen employers manage their pension plans more for the benefit of the shareholders than the participants, and this committee should explore how to ensure that pension plans continue to be the vehicles envisioned by Congress.

For one thing, employers moved away from the notion that assets in pension plans were essentially locked up for sole purpose of paying benefits to retirees. Among the practices documented in my book, *Retirement Heist*:

- Some employers, including Montgomery Ward, terminated their *healthy* pension plans and used the assets to pay creditors.
- Many, like Verizon, used the assets to finance downsizings, offering departing employees additional pension payouts in lieu of severance.
- Others, including DuPont, used pension assets to pay for retiree health benefits
- In less transparent maneuvers, companies sold pension assets in mergers and acquisitions, indirectly converting pension assets into cash.
- Employers took advantage of tax loopholes to carve out parts of the tax-subsidized pension plans for the rank-and-file to pay for supplemental executive pensions and deferred compensation for highly paid employees. The arrangements are called QSERPs, which stands for "qualified supplemental executive retirement plans." Using this technique, for example, Intel was able to move more than \$200 million in unfunded obligations for deferred compensation for the top 3% to 5% of its workforce into the pension plan. Participants can later roll their QSERP into an IRA.

Employers' ability to treat pension plans like tax-sheltered piggy banks rendered pension plans less well funded, and more likely to fail. It also meant that employers had an incentive to cut pensions and freeze plans—even when the plans were healthy-- because doing so increased the assets available for the employer.

Meanwhile, employers had another incentive to cut pensions: New accounting rules required companies to report pension obligations to shareholders, and their effect on quarterly income. Though intended to increase transparency, the rule had the unintended effect of rewarding companies that cut pension benefits. Doing so generated immediate profits for shareholders, and increased the surplus assets available to the employer.

Another thing to consider when evaluating the effectiveness of tax subsidies for pension plan is that the risk landscape has changed. When ERISA was enacted, employers bore the risk in pension plans (investment, interest rate, mortality) in exchange for the tax subsidies. But employers learned that they can essentially transfer investment and interest rate risk to participants by cutting pension benefits. When pension plans suffered losses, many employers responded by cutting benefits. (Replacing pensions with 401(k)s, of course, transfers *all* risk to the participants). Lump sum payouts are another way to transfer investment and interest rate risk, as well as inflation risk and longevity risk to retirees.

Taking risk transfer even further, a growing number of companies, including General Motors and Verizon, are transferring certain pension obligations to insurance companies, which take over the task of making monthly payments to retirees.

Companies benefit from this “de-risking” strategy, and insurers welcome the assets and fees for managing them, but retirees potentially face solvency risk, because their pensions no longer enjoy the protections of the federal Pension Benefit Guaranty Corp., which steps in to pay pensions if a plan fails.

The concept of “de-risking” requires greater scrutiny to insure there are no replays of 1980s debacles, when companies terminated pension plans and turned the job of paying out pensions to insurers like Executive Life, which became insolvent, causing retirees to lose significant amounts of their pensions.

Even more disturbing, some companies are offering lump sum window “opportunities” to already retired individuals. The lump sum option typically has far less value than the annuity that is already being paid, and many of the people to whom this option is offered are in their late 70s and 80s and some of them will be suffering from diminished capacity. Those who take lump sums are exchanging a secure stream of payments they cannot outlive, and taking on the challenge of investing the money and making it last.

The effectiveness of tax subsidies in 401(k) Plans

With employers freezing and terminating their pensions, and offloading liabilities to insurance companies and individuals, 401(k)-style savings plans have become the primary vehicle for retirement savings. The problem is that although the U.S. Treasury foregoes billions of dollars every year to encourage retirement saving, the workers who most need a supplement to Social Security either get nothing or very little from these plans.

According to the Center for Retirement Research, only about half of private sector workers participate in a workplace retirement plan, and roughly one-third of households reach their sixties with no retirement plans at all.

The reality is that a disproportionate amount of the tax expenditure ends up benefitting affluent employees who are already saving. Two-thirds of the value of tax expenditures for retirement savings plans goes to households in the top income quintile, according to the Urban-Brookings Tax Policy Center.

Many blame low savings rates on the behavior of low and middle income workers: failing to contribute, or contributing too little, making poor investment choices, or cashing out what little they have accumulated to pay for pressing needs like health care, rent, college tuition, and home attendants for their elderly parents.

But there are also other reasons. For example, millions of workers who are excluded altogether from participation in their employer's retirement plans. Although 401(k)s and other retirement plans are supposed to be made available to the broad base of employees, and not just a select group, employers are permitted to exclude 30% of workers for any reason, and even more if they follow certain rules. They can exclude workers in certain divisions, or geographic areas and job classifications. They may also exclude those who work fewer than 1,000 hours in a 12-month period, which can effectively eliminate part-timers and seasonal workers; people under age 21, and workers covered by collective bargaining agreements.

Excluding low-paid workers who are not likely to contribute or contribute very little makes it easier for the retirement plans to pass discrimination tests, which compare the contributions of low-paid to those of high paid, to ensure that the plan doesn't unfairly benefit the top echelon. If too few of the lower paid participate, and contribute too little, a plan can appear discriminatory, which can bring down the maximum amount the high-paid can contribute. One way to ensure that low participation by lower paid workers doesn't make the plan appear discriminatory is to exclude many of them altogether.

One example in my book is Hugo Boss, a company that makes high-end clothing. For years, the company excluded workers in its warehouse in Midway, Georgia, from the 401(k) plan that it offered to the 232 employees and managers at its Cleveland headquarters. Low participation and contributions from the low-paid warehouse workers, mostly minority women, would have caused the plan to fail the discrimination tests. When that happens, the limits on what the highest paid employees can contribute are lower than the statutory maximum, which currently is \$17,500 plus a \$5,500 catch-up contribution for those 50 and over.

Thus, those who need savings incentives the most are shut out of plans to ensure that those who need help the least can contribute the maximum amount.

A recurring theme I've seen since the '80s is that many employers want to maintain the plans primarily for the benefit of their higher paid employees, and with the help of benefits consulting firms, use increasingly complex maneuvers to sidestep the discrimination rules and skew benefits to the highly paid. These include segregating lower-paid workers in separate but unequal plans, and providing larger contributions to higher-paid workers, a nearly universal practice common in pension plans, called "permitted disparity." Younger and lower-income workers are also more likely to forfeit employer contributions because they don't remain on the job long enough to vest.

Employers have persistently sought relief from discrimination rules, and lobbied successfully for the automatic enrollment provision included in the Pension Protection Act, which became effective in 2007. Although sold as a way to improve participation among the low-paid, who are automatically enrolled in a plan, the benefit to employers is that merely by providing automatic enrollment (even if workers opt out), and making a modest matching contribution to an employee's account, the plans don't have to prove that they are benefiting lower paid employees.

It remains to be seen whether auto-enrollment will provide a meaningful benefit for the low-paid. Employees can drop out at any time, aren't required to contribute, can use the plan as a piggy bank for immediate spending needs, and must work for three years before they vest in the employer contributions. Meanwhile, only *non-excluded* employees are auto-enrolled, and employers can continue to take advantage of "permitted disparity" to provide richer contributions to the highest paid employees in the plans.

Looking ahead

Using tax breaks as carrots to encourage savings is potentially a good thing, but more scrutiny is needed to determine how to structure them to work more efficiently.

For example, the increase in 401(k) limits in 2001 (and indexed to inflation) has not significantly increased the number of retirement plans or the percentage of people participating. [Currently, the maximum combined employer-employee contribution to a 401(k) is \$52,000.]

A rollback of contribution levels, or at least a freeze at the current level might be something to consider. According to the GAO, only a small percentage of workers contribute the maximum to their plans. Contribution ceilings do not jeopardize the ability of more affluent employees to save on a tax deferred basis. Many of the highest paid participate in deferred compensation plans that enable them to save significant amounts above the contribution limits. Savings in these parallel 401(k)s receive employer contributions, can be invested in virtual versions of the same funds available in the 401(k), and enjoy grow tax deferred growth.

In any discussion of tax expenditures, it would be illuminating to measure revenue loss attributable to the billions of dollars that highly paid employees set aside each year in deferred compensation plans and supplemental executive pensions plans, which at some companies exceed the amounts owed regular workers.

And we need more information from employers.

To get a clearer view of who benefits from tax-payer subsidized retirement plans, employers should once again be required to submit Schedule T of the Form 5500, which for each plan shows:

Total employees

Total number of excluded workers,

Number of excluded workers by classification:

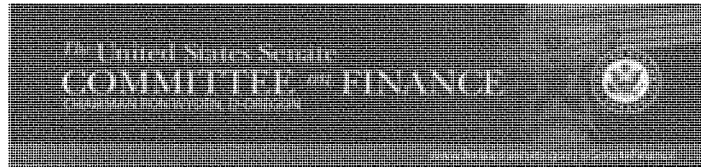
- * work fewer than 1,000 hours a year
- * worked less than one year
- * under 21
- * location (excluded division/unit)
- * job category
- * collectively bargained

Total participants in the plan

Number of participants with anything in their accounts

Demographic data would also be helpful when evaluating who benefits from qualified plans. Employers could be required to disclose the race, gender and ages of both participants and excluded employees.

Thanks you for your time. I'd be glad to answer any questions.



Wyden Hearing Statement on Retirement Savings and Tax Reform

Take a look at the state of retirement savings in the U.S., and it's clear that something is out of whack. The American taxpayer delivers \$140 billion each year subsidizing retirement accounts, but millions of Americans are nearing retirement with little or nothing saved. The incentives for savings in the tax code are not getting to the people who need them.

A pair of new studies spell out the issue. The Federal Reserve last month found that an employee with middle-of-the-pack savings has \$59,000 set aside for retirement. Yet according to the GAO, some 9,000 taxpayers have IRA accounts worth more than \$5 million. It would take several lifetimes of work for the typical middle-class American to save that much money.

So how did those massive IRA accounts come to be? In many cases, they're sweetheart stock deals that most investors would never have access to. Executives buy stocks at a special, rock-bottom price -- sometimes fractions of a penny per share -- and use an IRA as a tax shelter. The stocks start out dirt cheap, but just like that they turn to gold, and the IRA shoots up in value.

Wise investors have every right to use all the tools available to them, and no one should begrudge them their success. But IRAs were never intended to become tax shelters for millionaires -- they're designed to help typical Americans save for retirement.

As the Finance Committee continues to work on modernizing the tax code, it should take a good look at fixing this issue. With limited resources, it's crucial to use taxpayer dollars wisely.

That same study from the Federal Reserve included another alarming piece of information. Nearly a third of workers, according to the Fed, have no pension and nothing set aside for retirement.

It is a fact of today's economy that millions of Americans are unable to save. Report after report has shown that America's middle-class is -- at best -- struggling to stay afloat. Five years after the Great Recession, it remains tough for many people to find and hold a steady job. The cost of a college education is rising. Millions of Americans had their wealth tied up in their homes before the housing collapse, and they haven't come close to a full recovery. And a lot of working families' are seeing their take-home pay drop.

At the same time, workers -- especially younger ones -- are changing jobs more frequently than ever before, and they find it difficult to save without portable savings accounts. Women face special challenges to saving that need to be addressed. That's also true for part-time workers.

The Leave-it-to-Beaver ideal of a worker spending 40 years with one firm and retiring with a generous pension and a gold watch is sorely outdated. Retirement policies need to keep up with the times. The Finance Committee should examine these issues arising in today's economy.

One proposal worth looking at is being pursued by my home state of Oregon. Less than half of Oregon businesses offer retirement plans to their employees, and many Oregonians have trouble saving anything at all. So the state created the Retirement Savings Task Force to find solutions.

Just yesterday, the task force recommended the state set up an auto-IRA program for any Oregonian worker who is not covered by an employer retirement plan. A percentage of employees' paychecks would go into savings accounts, and contributions would grow with time.

It wouldn't be mandatory -- employees could opt out at any time -- but it has the potential to be a first step toward retirement security for many Oregonians.

In my view, the tax code should give all Americans the chance to get ahead, and making it easier to save is one of the best ways to accomplish that. That's why it's important for the committee to consider how to improve these incentives and ensure they're helping middle-class Americans prepare for retirement -- not helping millionaires shelter money.

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United States Government Accountability Office

Statement for the Record
To the Committee on Finance,
U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. ET
Tuesday, September 16, 2014

INDIVIDUAL RETIREMENT ACCOUNTS

Preliminary Information on IRA Balances Accumulated as of 2011

Statement for the Record of James R. McTigue
Director, Strategic Issues

Charles A. Jeszeck,
Director, Education Workforce, and Income Security
Issues

GAO Highlights

Statement of GAO-14-878T, a statement for the record to the Committee on Finance, U.S. Senate

Why GAO Did This Study

In 2014, the federal government will forgo an estimated \$17.6 billion in tax revenue from IRAs. Congress limited annual contributions to IRAs to prevent the tax-deferred accumulation of unduly large balances, but comments have been raised that tax benefits accrue primarily for higher-income individuals.

This statement provides preliminary observations based on ongoing work on information on IRA balances in terms of reported fair market value aggregated by taxpayers. GAO analyzed 2011 IRS statistical data. The unit of analysis was the taxpaying unit, and a tax return, such as a married couple filing jointly, may include more than one IRA owner. Aggregate balances include inherited IRAs that are not readily identified in the IRS data. GAO developed two scenarios to illustrate how much a person could have contributed given statutory limits on contributions from 1974 to 2011. GAO calculated hypothetical accumulations using historical stock market returns as well as what return rates would be necessary to accumulate balances of \$1 million or \$5 million under each contribution scenario. GAO also calculated the IRA accumulation assuming the optimal historical interest rates as reported in the Social Security Trustees reports.

What GAO Recommends

GAO is not making recommendations in this statement. GAO will release a separate report with its final results on individual retirement accounts later this fall. GAO discussed the information in this statement with Department of the Treasury and IRS officials and they agreed with the information as presented.

View GAO-14-878T. For more information, contact Charles A. Jankovitz at (202) 512-7125 or jankovitz@ga.gov or James R. McIntyre, Jr. at (202) 512-4113 or mcintyre@ga.gov.

September 2014

INDIVIDUAL RETIREMENT ACCOUNTS

Preliminary Information on IRA Balances Accumulated as of 2011

What GAO Found

For tax year 2011 (the most recent year available), an estimated 43 million taxpayers had individual retirement accounts (IRA) with total reported fair market value of \$5.2 trillion. About 99 percent of those taxpayers had aggregate IRA balances (including inherited IRAs) of \$1 million or less. As shown in the table below, few taxpayers had aggregated balances exceeding \$5 million as of 2011. Generally, taxpayers with IRA balances of \$5 million or more tend to have higher adjusted gross incomes, be joint filers, and 65 or more years old. The Internal Revenue Service (IRS) statistical data GAO analyzed may not provide a precise estimate of the number of taxpayers or other quantities when the number of taxpayers in a particular reporting group is very small. Even assuming maximum contributions sustained over decades and rolled over from an employer plan, it would take an aggressive stock market investment strategy to accumulate an IRA balance over \$5 million. There is no total statutory limit on IRA accumulations or rollovers from employer defined contribution plans. An individual who made the maximum contributions every year since 1975 to a traditional IRA could have accumulated about \$303,420 achieving investment returns equal to the average annual Social Security interest rates.

Estimated Taxpayers with IRA by Size of IRA Balance, Tax Year 2011

IRA Balance	Number of taxpayers		Total IRA fair market value balances (\$ Billions)	
	Estimate	95% confidence interval	Estimate	95% confidence interval
\$1 million or less	42,382,192	42,094,009 - 42,670,375	\$4,092	\$4,038 - \$4,147
> \$1 million to \$2 million	502,392	470,897 - 533,887	674	632 - 717
> \$2 million to \$3 million	83,529	72,632 - 94,426	198	173 - 224
> \$3 million to \$5 million	36,171	30,811 - 41,531	133	114 - 153
> \$5 million to \$10 million	7,952	6,120 - 9,783	52	40 - 64
> \$10 million to \$25 million	791	596 - 985	11	8 - 13
> \$25 million	314	115 - 650	81	8 - 225

Source: GAO analysis of IRS data. | GAO-14-878T.

Notes: The taxpayer reflects a taxpaying unit including individuals as well as couples filing jointly which may have more than one IRA owner. The IRA balance aggregates the value of all IRAs owned, including inherited IRAs.

Chairman Wyden, Ranking Member Hatch, and Members of the Committee:

We are pleased to submit this statement on how much taxpayers have accumulated in their individual retirement accounts (IRA). This statement is based on our report on IRAs that is due to be released later this fall and, therefore, the findings should be regarded as preliminary.

Enacted as part of the Employee Retirement Income Security Act of 1974 (ERISA), IRAs are a key vehicle for individuals to save for retirement. IRAs also are increasingly important as a way for individuals to roll over savings from pension plans. Most eligible taxpayers do not take advantage of IRAs as an opportunity to save for retirement, and concerns have been raised that tax benefits accrue primarily for higher income individuals.

In 2014, tax-preferred treatment for IRAs will result in the federal government forgoing an estimated \$17.5 billion in net income tax revenue, according to estimates by the U.S. Department of the Treasury (Treasury).¹ To limit the amount of federal revenue forgone and use by higher-income individuals, IRAs are subject to a total annual contribution limit, as well as some income and other limits on eligibility. In addition, some IRA types require minimum distributions starting at age 70½. The tax code also imposes an additional tax on excess contributions and early withdrawals. However, the tax code does not place any total limit on how much an IRA can accumulate.

¹See Office of Management and Budget, *Fiscal Year 2015 Analytical Perspectives: Budget of the U.S. Government* (Washington, D.C.: 2014). The revenue loss is measured as the tax revenue that the government does not currently collect on contributions and earnings amounts, offset by the taxes paid by those who are currently receiving retirement benefits. The Joint Committee on Taxation estimates that IRAs will result in about \$17.6 billion in revenue losses in 2014. Revenue loss estimates do not represent the amount of revenue that would be gained from repealing a tax expenditure because repeal would probably change taxpayer behavior in some way that would affect revenue. Treasury also estimates that the present value of the revenue effects, net of future tax payments, from exclusions on traditional IRA contributions and earnings, Roth earnings and distributions, and non-deductible IRA earnings for calendar year 2013 was \$1.7 billion, \$3.4 billion, and \$150 million respectively.

This statement is based on preliminary findings from our ongoing audit examining IRA balances.² As requested, this statement describes the number and types of taxpayers with IRAs and the size of their IRA balances in terms of reported fair market value (FMV). We analyzed individual tax data for tax year 2011 (the most recent year available) from the Internal Revenue Service's (IRS) Statistics of Income (SOI) database. We analyzed these data by size of IRA FMV as reported by IRA custodians to IRS. Because SOI samples tax returns and taxpayers may have multiple IRAs, we aggregated IRA data (including inherited IRAs as IRS data do not readily identify inherited IRAs) by tax return. Our unit of analysis was the taxpaying unit, and a tax return, such as for a married couple filing jointly, may include more than one IRA owner. Our analysis of SOI statistical data is subject to sampling errors because the SOI data set is based on a sample of tax returns as filed.³ In addition, the data do not reflect IRS audit results. To assess the reliability of the statistical data we analyzed, we reviewed IRS documentation and interviewed agency officials familiar with the data. We determined that these data were sufficiently reliable for the purposes of this report. However, the IRS SOI sample may not provide a precise estimate of the number of taxpayers or other quantities when the number of taxpayers in a particular reporting group is very small.⁴ To give perspective on what might be considered a large IRA, we developed two scenarios to illustrate how much a person could have contributed given statutory limits on contributions from 1975 to 2011. We calculated hypothetical accumulations using historical stock market returns as well as what return rates would be necessary to accumulate balances of \$1 million or \$5 million under each contribution scenario. Additionally, we calculated the accumulated balance in the IRA account assuming the account grew at the nominal historical interest

²Our forthcoming report will go into additional detail on how IRAs can become large and also examines enforcement of IRA laws by IRS.

³All percentage estimates derived from samples used in this statement have 95 percent confidence intervals that are within plus or minus 1 percentage point of the estimates themselves, unless otherwise specified. All other types of estimates in this statement have 95 percent confidence intervals that are within plus or minus 15 percent of the estimates themselves, unless otherwise specified.

⁴Estimates based on the small group of taxpayers we studied may have confidence intervals wider than 15 percent of the estimates themselves. Our estimates related to the larger IRA balances are less precise as the number of filers in these categories decrease. About 5 percent of the estimated taxpayers with IRAs had at least one associated IRA with blank FMV information. We treated the blank FMVs as zeros. If these IRAs did not, in fact, have zero balances, they could affect our estimates' upper bound considerably.

rates as reported in the Social Security Trustees reports. We discussed the information in this statement with Treasury and IRS officials and they agreed with the information as presented.

We conducted the work on which this statement is based from June 2013 through September 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In summary, most taxpayers have accumulated IRA balances less than \$1 million, and few taxpayers have accumulated \$5 million or more in their IRAs. Even assuming maximum contributions sustained over decades and rolled over from an employer plan, it would take an aggressive stock market investment strategy or investments in assets unavailable to most investors to accumulate an IRA balance over \$5 million. An individual who made the maximum contributions every year since 1975 to a traditional IRA would have accumulated about \$303,420 achieving investment returns equal to the historical interest rates reported by the Social Security Trustees for special issue government bonds.

Background

IRAs serve dual roles by (1) providing a way for individuals not covered by a pension plan to save for retirement and (2) providing a place for retiring workers or individuals changing jobs to roll over, or transfer, their employer-sponsored plan balances.

During the past 40 years, several types of IRAs with different features for individuals and small businesses have been authorized. Two types of IRAs are geared toward individuals—each with its own federal income tax benefits: traditional IRAs and Roth IRAs. Traditional IRA contributions, subject to certain limitations, can be deducted from taxable earnings. Taxes on earnings are deferred until distribution. In contrast, Roth IRA contributions are made after tax and distributions are tax free.

Two other types of IRAs are intended to encourage savings sponsored through small business employers. Simplified Employee Pension (SEP) IRAs were designed with fewer regulatory requirements than traditional employer pension plans to encourage small employers to offer pension plans to their workers. Savings Incentive Match Plan for Employees

(SIMPLE) IRAs help employers with 100 or fewer employees more easily provide a retirement savings arrangement to their employees.

Individuals can roll over assets from employer-sponsored plans into traditional or Roth IRAs.⁵ Employers may sponsor two broad types of plans: (1) defined benefit (DB) plans, which promise to provide benefits generally based on an employee's years of service and frequently are based on salary, regardless of the performance of the plans' investments, and (2) defined contribution (DC) plans, in which benefits are based on contributions and the performance of the investments in participants' individual accounts. Over the last three decades, employers have shifted from sponsoring DB plans to DC plans. The 401(k) plan is the predominant type of DC plan in the United States. Typically, 401(k) plans allow participants to specify the size of their contributions and direct those contributions to one or more investments among the options offered within the plan.

For DB plans, benefits are limited to amounts needed to provide an annual benefit no larger than the lesser of a specific dollar amount (\$210,000 for 2014) or 100 percent of the participant's average compensation for the highest 3 consecutive calendar years. An individual receiving a lump sum distribution from a qualified plan may defer taxes by rolling the lump sum into a traditional IRA. Whereas DB plans have a limit on total benefits, DC plans (like IRAs) have annual contribution limits but no total limit on how much an account can accumulate.

IRA custodians are responsible for ensuring that all IRA assets (including those not publicly traded) are valued annually at their FMV and are required to report the account's FMV at year-end to IRS. The FMV is the value reflecting contributions and rollovers into the IRA, distributions from the IRA, investment earnings (such as interest and dividends), and any change in the market value of assets held in the IRA. Nonpublicly-traded assets do not have easily determined FMV.

⁵Rolling employer retirement balances into an IRA is one of several options available and may not be the best choice depending on an individual's circumstances. See GAO, *401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants*, GAO-13-30 (Washington, D.C.: Mar. 7, 2013).

Most Taxpayers Have IRA Balances Below \$1 Million, but Some Have Balances that Exceed \$5 Million

For tax year 2011 (the most recent year available), an estimated 43 million taxpayers had IRAs with total reported FMV of \$5.2 trillion.⁶ About 42.4 million (99 percent) of those taxpayers had aggregate IRA balances of \$1 million or less, with a median accumulated IRA balance around \$34,000. Around 600,000 taxpayers had aggregate IRA balances exceeding \$1 million, with a median of around \$1.4 million. As shown in table 1 below, few taxpayers had aggregated balances exceeding \$5 million as of 2011. A number of taxpayers had IRA balances exceeding \$25 million though our estimates varied from around 115 to more than 600 taxpayers. Some of these taxpayers had very large aggregate IRA balances.

Table 1: Estimated Taxpayers with IRAs by Size of IRA Balance, Tax Year 2011

IRA Balance	Number of taxpayers			Total IRA fair market value balances (\$ Billions)		
	Estimate	95% confidence interval		Estimate	95% confidence interval	
All taxpayers with IRAs	43,013,341	42,725,706	43,300,975	\$5,241	\$5,083	\$5,399
\$1 million or less	42,382,192	42,094,009	42,670,375	4,092	4,038	4,147
> \$1 million to \$2 million	502,392	470,897	533,887	674	632	717
> \$2 million to \$3 million	83,529	72,632	94,426	198	173	224
> \$3 million to \$5 million	36,171	30,811	41,531	133	114	153
> \$5 million to \$10 million	7,952	6,120	9,783	52	40	64
> \$10 million to \$25 million	791	596	985	11	8	13
> \$25 million	314	115	650	81	8	225

Source: GAO analysis of IRS data. | GAO-14-878T

Notes: The taxpayer, as a taxpaying unit, may have more than one IRA owner. The IRA balance aggregates the value of all IRAs owned, including inherited IRAs. We assumed all blank IRA fair market values are zero; the blank values could affect these estimates considerably.

⁶We use taxpayer to denote the taxpaying unit including individuals, heads of households, and married couples filing a joint return. IRAs owned by dependents are aggregated with the filer's IRA. Taxpayers included those filing a return but reporting no taxable income—for example those with incomes below a certain threshold. We report aggregated IRA balances for taxpayers as individuals can own more than one IRA. The aggregate balance includes inherited IRAs, as the IRS data do not readily identify inherited IRAs. We did not include information about IRA owners who did not file an individual income tax return. However we have no evidence from the IRA dataset that there were IRA owners with unusually large IRA balances who did not file an income tax return for 2011.

Generally, taxpayers with IRA balances of \$5 million or more tend to have higher adjusted gross incomes, be joint filers, and are 65 or more years old.⁷

For the years covered in our analysis, IRS did not collect information about IRA asset types; therefore, we cannot describe the types of investments that may be associated with the total value of the IRAs.

While there is no total limit on IRA or DC plan accumulations, scenarios illustrating the maximum annual contributions over time can shed light on what could be considered a large IRA. Table 2 illustrates total contributions by an individual assuming (1) maximum contributions every year since IRAs were created under ERISA, and (2) maximum employer and employee contributions since 401(k) plans were created in the 1980s.⁸ These scenarios represent the upper bounds on allowable contributions and do not represent how much individuals and employers typically contribute. Some may not have sufficient income to even approach the employee limit or might not have an employer able or willing to provide additional contributions up to the maximum combined employee plus employer limit. For 2011, the limit for combined employer-employee contributions (including catch-up contributions for those aged 50 and older) totaled \$54,500, with the employee contribution limit (also including catch-up contributions) being \$22,000. Few, if any, individuals would sustain maximum contributions for more than three decades, given that in practice, few individuals contribute the maximum to an IRA or employer DC plan in any given year. Further, few, if any, individuals would be employed by employers who made matching and additional contributions for more than three decades at a level high enough to reach the combined employee plus employer limit. Our previous work estimated that only one-tenth of 1 percent of plan participants had contributions at or above the combined employer-employee contribution limit for 2010.⁹ Nonetheless, to illustrate possible accumulations under these upper bounds for contributions, the scenarios assume all contributions are

⁷Taxpayers were classified in the age 65 and older group if the filer, spouse, or both were age 65 or older.

⁸Both scenarios assume catch-up contributions for those age 50 and older beginning in 2002.

⁹GAO, *Private Pensions: Pension Tax Incentives Update*, GAO-14-334R, (Washington, D.C.: Mar. 20, 2014).

invested in a broad stock market index—specifically, the Standard and Poor's (S&P) 500—and do not reflect any withdrawals or investment fees.¹⁰ This would be an aggressive investment strategy for an individual to sustain over more than three decades.¹¹

Table 2: Hypothetical Rates of Return Needed to Accumulate IRA Balances of \$1 Million or \$5 Million under Two Illustrative Contribution Scenarios, 1975-2011

Scenario	Total contributions	Balance invested in S&P 500 portfolio	S&P 500 rate of return ^a		Dollar-weighted rate of return to accumulate \$1 million ^a	Dollar-weighted rate of return to accumulate \$5 million ^a
			Geometric mean	Dollar-weighted		
Maximum IRA contributions (1975-2011) ^b	\$99,500	\$353,379	8.2%	7.1%	11.6%	18.0%
Maximum combined employer-employee contributions (1980-2011) ^c	\$1,185,350	\$3,959,753	8.0%	6.9%	n.a. ^d	8.0%

Source: GAO analysis based on statutory contribution limits | GAO-14-878T

Notes: All scenarios reflect contributions by an individual with catch-up contributions beginning in 2002. Scenario results do not reflect investment or administrative fees and expenses. Likewise, the scenarios do not reflect any withdrawals or employer plan loans over the period. n.a. = not applicable.

^aS&P 500 rate of return is calculated as the geometric mean (which is sometimes referred to as the compounded annual growth rate) on a time-weighted basis, which means that each year's rate of return receives equal weighting in calculating the mean. We calculated the dollar-weighted return, which takes into account the intersection of the timing of cash flows into or out of the account and the timing of the investment returns. For example, because new money is being contributed to the account every year, a rate of return in a later year is more important than a rate of return in an earlier

¹⁰As with retirement plans, leakages from IRA accounts may occur when IRA owners use their accumulated savings prior to retirement for non-retirement purposes, thereby reducing the accumulated balances. Fees charged for such services as investment management, recordkeeping, consulting, and customer service, can also reduce accumulated savings. DC plan fees can range from an average of 0.15 to 1.33 percent of assets depending on the size of the plan. GAO, *401(k) Plans: Increased Educational Outreach and Broader Oversight May Help Reduce Plan Fees*, GAO-12-325 (Washington, D.C.: Apr. 24, 2012). An additional 1 percent annual charge for fees could reduce an individual account balance by 17 percent over a 20-year period. GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, GAO-07-21, (Washington, D.C.: Nov. 16, 2006).

¹¹The scenarios illustrate balances accumulated by an individual in an IRA or DC plan. In contrast, for our analysis of IRA balances using SOI estimates, we examined aggregate IRA balances by taxpaying unit. A tax return could include more than one person, such as a married couple filing a joint return.

year because more money is at stake in the later years. The dollar-weighted annual rate of return adjusts for this and thereby measures the actual performance of the account under the given investment strategy. For more information on alternative return measures, see GAO, *Pension Plan Valuation: Views on Using Multiple Measures to Offer a More Complete Financial Picture*, GAO-14-264 (Washington, D.C.: forthcoming).

^bThe IRA scenario reflects maximum allowable contributions to a traditional IRA. For a Roth IRA, the maximum contributions for 1998 to 2011 would be \$57,000.

^cThis scenario reflects the upper bound on contributions to a single employer DC plan. Our prior work has shown that about one-tenth of 1 percent of DC plan participants contributed at or above the combined employer-employee contribution limit for 2010.

^dContributions alone accumulated from 1980 to 2011 exceed \$1 million.

As shown in table 2 above, it would take double-digit rates of return—well in excess of the S&P 500 return over the period—to achieve a balance of \$1 million or more assuming an individual made only IRA contributions. Even accounting for the maximum possible—albeit improbable—combined employer-employee contributions and assuming an aggressive stock investment strategy, the DC plan scenario would need to achieve an average rate of return, over more than three decades, matching that of the S&P 500 index return to accumulate an individual account balance of \$5 million or more. Such an accumulation also looks large in comparison to what can be substantial rollovers of lump sum payouts from an employer DB plan.¹² For 2011, the maximum lump sum payable to a 65-year-old DB participant would have ranged from \$2.3 million to \$2.6 million, depending on the interest rate factors used in the lump sum calculations. For these reasons, one could conservatively consider an IRA balance (accumulated by an individual) greater than \$5 million to be large.

An individual who decided to make maximum contributions to an IRA each year since ERISA created IRAs but uses a more risk-averse investment strategy will also be unlikely to achieve a balance of \$1 million or more. As shown in table 3, an individual who achieves investment returns equal to historical interest rates reported by the Social Security trustees for special issue government bonds would accumulate a balance of \$303,420. This is about \$50,000 less than if the individual had invested in the S&P 500 over the same period, as shown in table 2. This analysis also does not reflect any withdrawals or investment fees.

¹²Some DB plans allow participants to receive a lump sum payment in place of what would otherwise be regular benefit payments. In 2011, the total limit on an annual DB benefit payment was \$195,000.

Table 3: IRA Accumulations Assuming Maximum Contributions and a Rate of Return Based on Historical Interest Rates Reported by the Social Security Trustees

Scenario	Total contributions	Balance assuming investment returns equivalent to Social Security interest rates ¹
Maximum IRA contributions (1975-2011) ²	\$99,500	\$303,420

Source: GAO analysis based on statutory contribution limits. | GAO-14-878T

Notes: The scenario reflects contributions by an individual with catch-up contributions beginning in 2002. Scenario results do not reflect investment or administrative fees and expenses. Likewise, the scenario does not reflect any withdrawals over the period.

¹We obtained historical average annual interest rates from annual reports by the Board of the Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds for 1995, 2003, and 2014. These average annual interest rates represent the average nominal rates, which compound semiannually, for special U.S. Government obligations issued to the Social Security trust funds in each of the 12 months of each year from 1975 through 2011.

²The IRA scenario reflects maximum allowable contributions to a traditional IRA. For a Roth IRA, the maximum contributions for 1998 to 2011 would be \$57,000.

Chairman Wyden, Ranking Member Hatch, and Members of the Committee, this concludes our statement for the record.

If you or your staff have any questions about this statement, please contact James R. McTigue, Jr. at (202) 512-9110 or Charles A. Jeszeck at (202) 512-7215. You may also reach us by email at mctiguej@gao.gov or jeszeckc@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Key contributors to this statement include Tamara Cross and MaryLynn Sergent (Assistant Directors), Amy Bowser, Bertha Dong, Monica Gomez, Eric Gorman, Gene Kuehneman, Tom Moscovitch, Ed Nannenhorn, Albert Sim, Frank Todisco, Walter Vance, Sonya Vartivarian, and Craig Winslow. Other contributors to the report on which the statement is based are Joanna Berry, Rachel DeMarcus, Ellen Grady, David Lin, Karen O'Connor, Stewart Small, and Kathleen van Gelder.

COMMUNICATIONS

CHURCH ALLIANCE
Acting on Behalf of Church Benefits Programs

**STATEMENT FOR THE RECORD
OF
THE CHURCH ALLIANCE**

**FOR THE HEARING ON
“RETIREMENT SAVINGS 2.0:
UPDATING SAVINGS POLICY FOR THE MODERN ECONOMY”**

**BEFORE
THE U.S. SENATE
COMMITTEE ON FINANCE**

TUESDAY, SEPTEMBER 16, 2014

Chair: Ms. Barbara A. Boigegrain
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Chairman Wyden, Ranking Member Hatch, and members of the Senate Committee on Finance, thank you for the opportunity to submit this statement for the record on behalf of the Church Alliance.

The Church Alliance is a coalition of chief executive officers of thirty-eight (38) denominational benefit programs, covering mainline Protestant denominations, two branches of Judaism, and Catholic schools and institutions. These benefit programs, known as church plans, provide pensions and health benefits to more than one million clergy, lay workers, and their family members.

We applaud the Committee's leadership on retirement security issues. In particular, we commend Senator Cardin and Senator Portman for their introduction of S. 952, the "Church Plan Clarification Act." We appreciated the discussion between Chairman Wyden, Senator Cardin, and Senator Portman in support of this measure during the hearing and would like to urge enactment of this important legislation before the end of the 113th Congress.

CHURCH PLANS

Church benefit plans and programs have existed for many years; in fact, some were established as far back as the 1700s. Initially, many of these benefit programs were akin to benevolence programs in that they provided benefits to clergy in need. Over the years, however, the benefit programs expanded to more formally and systematically provide retirement and welfare benefits for clergy and church lay workers.

Church plans have developed structures and mechanisms that reflect the differing church polities (denominational organizational and governance structures) that they serve. In recognition of their unique status, most church retirement plans are exempt from the Employee Retirement Income Security Act of 1974 ("ERISA") and are instead subject to special laws and regulations that reflect the distinctive issues that these plans and churches confront. Church retirement plans are subject to stringent state and federal laws and regulations, including state fiduciary standards, state contract law, and Internal Revenue Code ("IRC" or "tax code") requirements. Church retirement plans ensure the stability of participants' investments by applying many of the same strong safeguards applied to corporate and public pension funds. Moreover, churches and synagogues have a strong lifelong relationship with employees and are motivated to provide for and serve the clergy and church lay workers who have dedicated their lives to working for religious institutions.

THE CHURCH PLAN CLARIFICATION ACT

Given the unique nature of church retirement plans, legislation and regulations oftentimes have unintended consequences when applied to them, which can result in uncertainty and/or compliance issues. The Church Plan Clarification Act contains critical corrections and clarifications to a series of issues impacting church retirement plans:

- **Controlled Group Rules.** Currently, the controlled group rules for tax-exempt employers may require certain church-affiliated employers to be included in one controlled group (i.e., treated as a single employer), even though they have little

relation to one another. A modification is necessary to the controlled group rules to ensure that multiple church-affiliated entities – which may be related theologically, but have little or no relation to one another in terms of day-to-day operation – are not inappropriately treated as a single employer under the tax code.

- **Grandfathered Defined Benefit (“DB”) Plans.** IRC § 403(b) church DB plans established before 1982 are called grandfathered DB plans and were intended to be treated and continue to operate as DB plans. However, recent rules subjecting such plans to both DB and defined contribution (“DC”) annual benefit accrual limitations under IRC § 415 have resulted in clergy who are lower-paid and closest to retirement being harmed. A clarification is required to ensure that only the logically applicable DB limitations apply to these plans.
- **Automatic Enrollment.** Church employers often cross state lines. State wage withholding laws differ from state to state, presenting barriers to offering auto-enrollment into church retirement plans. Federal legislation is needed to preempt these laws so that church retirement plans can include auto-enrollment features in their retirement plans just as non-church corporate plans are allowed to do without the uncertainty arising under the laws of certain states.
- **Transfers Between 403(b) and 401(a) Plans.** Current rules do not allow transfers and mergers between an IRC § 403(b) church retirement plan and an IRC § 401(a) qualified church retirement plan. Legislation is needed to provide for such transfers and mergers, providing a better alternative to terminating or having to maintain separate legacy plans. Such legislation will also decrease complexity and administrative costs for church employers, as well as confusion for employees.
- **81-100 Trusts.** Church benefits boards are legally allowed to commingle plan and non-plan church-related assets for investment purposes to allow churches the benefit of the board’s greater resources, investment skills, and market clout. A clarification is required to ensure that a widely used investment vehicle, 81-100 (2011-1) trusts, can accept such funds.

In short, the Church Plan Clarification Act is simple and straightforward clarifications and corrections legislation, that is non-controversial, has bipartisan support, and has not attracted any opposition. Moreover, although the policy issues addressed by the Church Plan Clarification Act may seem relatively “small,” they are extremely critical to the functioning and operation of church plans. The issues addressed by the Church Plan Clarification Act are becoming increasingly urgent. The longer this legislation is pending, the greater the burden is to church plan participants, most of whom are of modest means and have devoted their lives, and sometimes the lives of their families, to serving religious institutions.

CONCLUSION

The Church Alliance strongly urges that the Church Plan Clarification Act be enacted as expeditiously as possible before the end of the year. It is vital that individuals who dedicate their lives to religious service are not inappropriately disadvantaged.

The Church Alliance greatly appreciates the opportunity to submit these comments. We are pleased to serve as a resource to the Congress and the Committee on these and related matters. We look forward to our continued work together on these important issues. Thank you.



STATEMENT FOR THE RECORD

Submitted to the

UNITED STATES SENATE

COMMITTEE ON FINANCE

On

Retirement Savings 2.0: Updating Savings
Policy for the Modern Economy

Tuesday, September 16, 2014

COALITION TO PROTECT RETIREMENT

1800 Duke Street

Alexandria, VA 22314

On behalf of the Coalition to Protect Retirement (CPR), we would like to thank Chairman Wyden and Ranking Member Hatch for convening this hearing on the important topic of retirement savings policy. CPR is composed of the leading trade associations representing retirement plan sponsors, administrators, service providers, and related financial institutions. The coalition's mission is to encourage and support retirement savings for American workers through preservation of tax incentives critical to American workers' retirement security.

As we celebrate the 40th anniversary of the passage of the Employee Retirement Income Security Act of 1974 ("ERISA"), it is important to review the performance of the retirement savings system. The system should serve all Americans, affording an opportunity to provide economic security in retirement. Congress should build upon the strengths of the current system to improve workers' access to savings opportunities and retirement savings outcomes.

Access to a retirement savings vehicle is critical for individuals to be able to prepare for retirement. One avenue that assists millions of Americans to achieve a secure retirement is employer-provided retirement accounts. Employer-provided retirement accounts along with individual retirement plans has resulted in a widespread and successful retirement system that enables working Americans at all income levels to enjoy a financially secure retirement.

Employer-sponsored and individual retirement plans are key components of our nation's retirement system. Together with Social Security and individual savings, employer-sponsored and individual retirement plans produce significant benefits for America's working families. Private retirement plans in the United States paid out over \$3.96 trillion in benefits from 2001 through 2010, while public sector retirement plans distributed \$2.82 trillion during the same period, with both playing an essential role in providing retirement income for millions of our nation's senior citizens.¹ In 2011, there were approximately 640,000 private-sector defined contribution plans covering over 73 million participants.² Additionally, the Pension Benefit Guaranty Corporation insured approximately 44 million defined benefit plan participants in 2011.³ According to an Investment Company Institute analysis of the Survey of Consumer Finances, in 2010, 81% percent of near-retiree (age 55-64) households held pension assets.⁴

Congress has repeatedly recognized, on a bipartisan basis, the value of the current retirement system. For example, in 2012, over 120 members of Congress introduced a concurrent resolution reflecting a "Sense of Congress" that the current tax incentives for retirement plans should be maintained. Historically, Congress has supported the employer-based system through enhancements of many retirement vehicles. The tax incentives that Congress has created are

¹ Employee Benefit Research Institute (EBRI) tabulations of data from the Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts of the United States and the Department of Labor, Bureau of Labor Statistics, Consumer Price Index.

² *Private Pension Plan Bulletin, Abstract of 2011 Form 5500 Annual Reports*, U.S. Department of Labor Employee Benefits Security Administration, June 2013.

³ PBGC Pension Insurance Data Book, 2011, Pension Benefit Guaranty Association

⁴ Brady, Kimberly Burham, and Sarah Holden, *The Success of the U.S. Retirement System*, Investment Company Institute, December 2012.

an important impetus for individuals to save for retirement and for employers to offer plans under a voluntary system. It is important to understand that there is not a loss of tax revenue due to the deferment of money into retirement accounts. Quite the contrary - once a participant begins drawing down their account, payments are subject to taxation.

The current employer-sponsored retirement system is vital for American workers to be able to save for retirement. Employer-sponsored retirement plans are designed to work together with other personal savings and the Social Security program to provide meaningful income in retirement. These retirement plans work. Currently, tax-qualified retirement plans hold \$23 trillion in assets, of which about \$14.6 trillion is in salary deferral retirement plans – 401(k)-type, IRAs, and annuities.⁵ Employers have helped to make this happen – having contributed almost \$3.7 trillion to public and private retirement plans from 2001 through 2010.⁶ Additionally, tools that employers utilize, such as automatic enrollment and auto escalation, can ensure that employees utilize a retirement plan in the workplace.

This multitrillion dollar pool of capital helps to finance investments that enhance productivity and encourage business expansion. The tax treatment of employer-sponsored plans encourages business owners to provide a retirement plan for their employees; essentially, giving individuals the opportunity to save. These plans cover workers across the income spectrum. Under current law, retirement plans must cover and provide benefits to lower-income and middle-income employees. More than 70 percent of American workers making between \$30,000 and \$50,000 a year contribute to their own retirement when covered by a retirement plan at work.⁷ Many American workers also receive a retirement savings contribution from their employer. The Plan Sponsor Council of America survey reports that in 2011, 95.4 percent of 401(k) plans included an employer matching or non-elective contribution.⁸ In 2012, 68 percent of human resource professionals surveyed said their company provided a matching program for their employees – further increasing these accounts.⁹ Without the opportunity to save through payroll deduction, millions of Americans would not save for retirement. Changes to the tax treatment of retirement plans could have negative effect on capital markets and individual savings. These are important elements that legislators must consider.

CPR believes that Congress should continue to encourage and support retirement savings for American workers through preservation of current tax incentives critical to American workers’

⁵ *The U.S. Retirement Market, First Quarter 2014*, Investment Company Institute, June 2014.

⁶ EBRI tabulations of data from the Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts of the United States and the Department of Labor, Bureau of Labor Statistics, Consumer Price Index.

⁷ EBRI (2010) estimate using 2008 Panel of Survey of Income and Program Participation (SIPP) (covered by an employer plan) and EBRI estimate (not covered by an employer plan; IRA only).

⁸ *55th Annual Survey: 50/50 Annual Survey, Reflecting 2011 Plan Experience*, Plan Sponsor Council of America, September 2012.

⁹ *2012 Employee Benefits: The Employee Benefits Landscape in a Recovering Economy*, Society for Human Resource Management, June 2012.

retirement security. With more than 10,000 Americans retiring every day, the need for tax incentives to encourage and protect retirement savings has never been greater.¹⁰ This is especially true for Americans who are not on track to have adequate savings to support themselves once they leave the workforce. Congress should build upon the existing tax incentives for individuals and employers – to help Americans attain financial security during their retirement years and to avoid the need for more federal spending to support retirees facing economic hardship.

The current structure for employer-provided and individual retirement plans has resulted in a widespread and successful program to enable working Americans at all income levels to enjoy a financially secure retirement. Of course, employer-sponsored retirement plans alone may not be enough to prepare for retirement. Personal savings, knowledge of investment options, assessment of future expenses, including health and living expenses, are all components of making wise, sound decisions that will ensure the individuals can thoroughly enjoy their golden years.

The Coalition hopes to work with the Committee as it explores ways to improve Americans' retirement security.

The Coalition to Protect Retirement

American Council of Life Insurers
American Society of Pension Professionals & Actuaries
The ERISA Industry Committee
The ESOP Association
Insured Retirement Institute
Plan Sponsor Council of America
Securities Industry and Financial Markets Association
Society for Human Resource Management

¹⁰ D. Vera Cohn and Paul Taylor, Baby Boomers Approach 65 Glumly, Pew Research Center, December 20, 2010.



**Statement for the Record for Senate Finance Committee September 16, 2014
Hearing on "Retirement Savings 2.0 Updating Savings Policy for the
Modern Economy"**

Stephanie Silverman
President & Executive Director
Employee-owned S Corporations of America
805 15th Street, Suite 650
Washington, DC 20005

On behalf of the Employee-Owned S Corporations of America (ESCA), thank you for the opportunity to submit comments to the Senate Finance Committee. We commend the Committee for its continued focus on retirement savings and policy approaches to increase participation and access for the many Americans who are unable to save enough for a secure retirement.

ESCA, which represents employee-owned private companies that operate in every state across the nation, in industries ranging from rail supply to school photography, respectfully submits that a vital means of promoting retirement security for working Americans is to expand the availability of S corporation ESOPs for more companies and their workers.

At a time when nearly 46% of working Americans do not participate in an employer-sponsored retirement savings plan and almost 40% do not even have access to an employer-provided plan, America's private, employee-owned companies are providing their employee-owners with a retirement savings plan (with many having more than one) and that plan is funded by their companies.

Congress authorized the S corporation ESOP ("S ESOP") structure to encourage and expand retirement savings by giving hundreds of thousands of American workers in all 50 states the opportunity to have equity in the companies where they work. Today, S ESOPs accomplish exactly what Congress intended them to: promote retirement savings create jobs and generate economic activity.

Last year, Senators Ben Cardin and Pat Roberts reintroduced bipartisan legislation, S. 742, the *Promotion and Expansion of Private Employee Ownership Act of 2013*, that will:

- *Encourage owners of S corporations to sell their stock to an ESOP*
- *Provide additional technical assistance for companies that may be interested in forming an S corporation ESOP*
- *Ensure small businesses that become ESOPs retain their SBA certification*
- *Acknowledge the importance of preserving the S corporation ESOP structure in the Internal Revenue Code*

To date, 21 members of the Senate have cosponsored the bill and this includes 7 members of the Finance Committee. A similar, bipartisan measure was introduced in the House in June by 8 members of the House Ways and Means Committee (Reps. Reichert, Kind, Tiberi, Neal, Paulsen, Blumenauer, Boustany and Pascrell.)

As the Finance Committee contemplates measures to reform the Tax Code and increase access to retirement savings, we urge Senators to support tax policies that expand the availability of long-term retirement savings opportunities and economic growth through S corporation ESOPs.

Background on S Corporation ESOPs

A Subchapter S corporation is a business entity that provides flow-through tax treatment to its shareholders. An employee stock ownership plan ("ESOP") is a qualified defined contribution plan that provides a company's workers with retirement savings through their investments in their employer's stock, ***at no cost to the worker***. ESOPs are regulated by the Employee Retirement Income Security Act ("ERISA") just like pension funds, 401(k) plans, and other qualified retirement plans.

In 1996, in the Small Business Jobs Protection Act, Congress authorized the S corporation ESOP structure, effective January 1, 1998, with the goal of encouraging and expanding retirement savings by giving American workers a greater opportunity to have equity in the companies where they work.

In the Taxpayer Relief Act of 1997, Congress repealed the unrelated business income tax (UBIT) originally imposed on the ESOP for its share of S corporation income, enabling S corporation ESOPs to become a viable new business structure to benefit American workers. Seventeen years later, there are more than 2,600 S ESOP companies operating in every state of the nation, in industries ranging from heavy manufacturing to retail grocery stores, from construction to consulting. Because of the structure of S ESOP tax policy, S ESOPs are accomplishing exactly what Congress intended: generating unparalleled retirement savings for workers, providing good and resilient jobs in high-performing businesses, and creating important macroeconomic benefits in their communities.

Over the years, ESCA has worked closely with federal policymakers to ensure that S ESOPs hold true to their original purpose of encouraging broad employee ownership.

We collaborated with members of your committee in 2000-2001 to craft anti-abuse rules that became section 409(p) of the Internal Revenue Code. These rules, enacted in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), now mandate that S ESOPs provide for broad-based employee ownership and establish strict repercussions for violations.

As the report language for EGGTRA (H.R. Rep. No. 107-51, part 1, at 100 (2001) states: The Committee continues to believe that S corporations should be able to encourage employee ownership through an ESOP. The Committee does not believe, however, that ESOPs should be used by S corporation owners to obtain inappropriate tax deferral or avoidance.

Specifically, the Committee believes that the tax deferral opportunities provided by an S corporation ESOP should be limited to those situations in which there is broad-based employee coverage under the ESOP and the ESOP benefits rank-and-file employees as well as highly compensated employees and historical owners.

Since enactment, Section 409(p) has been highly effective in ensuring that S ESOPs serve their purpose. As a result, S ESOPs have become perhaps the most effective retirement savings plan under federal law, and today the average S ESOP plan participant has between three and nine times saved in their ESOP account than they do in their 401(k) account.

The Unparalleled Performance of S ESOPs

Many studies over the years have documented why and how S ESOPs have proven to be so powerful for both workers as a retirement savings and economic security tool, and how they have contributed substantially to communities and the broader national economy:

In a new study released in June, data compiled by the National Center for Employee Ownership (NCEO) shows that private employee-owned businesses have strikingly fewer loan defaults than other businesses. **NCEO finds that the default rate on bank loans to ESOP companies during the period 2009-2013 was, on average, an unusually low 0.2 percent annually.** By contrast, mid-market companies in the U.S. typically default on comparable loans at an annual rate of 2 to 3.75 percent. The tenfold difference between the economic strength of employee-owned companies and other businesses highlights the fact that **private businesses which are owned by their employees have the incentives and vision that makes them more stable, more successful, and better for employees as well as the larger economy.**

A 2012 study by Alex Brill, tax advisor to the Simpson-Bowles deficit reduction commission and a former chief economist and policy director to the Ways and Means Committee, found that:

- Employment among surveyed S ESOP firms increased more than 60% from 2001-2011, while the private sector as a whole had flat or negative growth in the same period.
- In the struggling manufacturing industry in particular, the S ESOP structure has buffered against economic adversity and job loss.
- S ESOPs have significantly expanded the pool of US workers who are saving for retirement, while also boosting company productivity – something that has greatly benefited their employee-owners.

In his study, Brill notes that “in the context of the current tax reform debate that seeks to curtail existing tax expenditures in favor of lower statutory rates, policymakers should recognize the evidence in support of S ESOPs and their positive economic contribution.”

In 2013, Brill produced a follow-on study entitled “Macroeconomic Impact of S ESOPs on the U.S. Economy.” Key findings of that broader assessment revealed that:

- **the number of S ESOPs and the level of active participation (number of employee-owners) have more than doubled since 2002.**
- **total output from S ESOPs and the industries they support is nearly 2 percent of GDP.**
- S ESOPs directly employ 470,000 workers and support nearly a million jobs in all.
- S ESOPs paid \$29 billion in labor income to their employees, with \$48 billion in additional income for supported jobs.

Brill’s study on the macroeconomic impact of S ESOPs built upon findings issued in 2008, in a 2008 University of Pennsylvania report, whose authors found that S ESOPs contribute ***\$14 billion in new savings for their workers each year beyond the income those workers otherwise would have earned***, and that S corporation ESOPs offer workers greater job stability and increased job satisfaction. The study also found that S corporation ESOPs’ higher productivity, profitability, job stability and job growth generate a collective ***\$19 billion in economic value that otherwise would not exist***.

The Brill and University of Pennsylvania studies reinforce other important evidence about S ESOPs that show how powerful they can be.

In a 2010 Georgetown University/McDonough School of Business study, two leading tax economists, former Treasury Department officials Phillip Swagel and Robert Carroll, reviewed the performance of a cross-section of S corporation ESOP companies during the early part of the prior recession and found that these companies performed better than other equivalent companies in terms of job creation, revenue growth, and worker retirement security. Specifically, Swagel and Carroll found that:

- **Companies that are S corporation ESOPs are proven job-creators, even during tough times.** While overall U.S. private employment in 2008 fell by 2.8%, employment in surveyed S corporation ESOP companies rose by 2%. Meanwhile, 2008 wages per worker in surveyed S corporation ESOP companies rose by 6%, while overall U.S. earnings per worker grew only half that much.
- **S corporation ESOP companies provided substantial and diversified retirement savings for their employee-owners at a time when most comparable companies did not.** Despite the difficult economic climate, surveyed S corporation ESOP companies increased contributions to retirement benefits for employees by 19%, while other U.S. companies increased their contributions to employee retirement accounts by less than 3%.

The National Center for Employee Ownership ("NCEO") found that S corporation ESOPs are a major force in providing retirement security to workers. A 2005 NCEO survey reported that S corporation employee-owners had ESOP account balances **three to five times higher than the U.S. average for 401(k) plan participants**. For S corporation employee-owners nearing retirement, ESOP account balances were **five to seven times the average**. Some 80 percent of companies surveyed by NCEO offer their employees more than one qualified retirement plan.

As the Senate Finance Committee continue to work on comprehensive tax reform, ESCA would be pleased to serve as a resource and we look forward to continuing this important dialogue about a retirement savings plan that is working and enabling hundreds of thousands of Americans to achieve the American dream at work.

The Employee-Owned S Corporations of America ("ESCA") is the Washington, DC voice for employee-owned S corporations. ESCA's exclusive mission is to advance and protect S corporation ESOPs and the benefits they provide to the employees who own them. These companies have an important story to tell policymakers about the tremendous success of the S ESOP structure in generating long-term retirement savings for working Americans and their families. ESCA provides the vehicle and the voice for these efforts. ESCA represents employee-owners in every state in the nation.



The
ERISA
Industry
Committee

September 16, 2014

Senate Committee on Finance
Attn. Editorial and Document Section
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Dirksen Senate Office Bldg.
Washington, DC 20510-6200

RE: Retirement Savings 2.0: Updating Savings Policy for the Modern Economy hearing on September 16, 2014

Dear Senator Wyden:

As the representative of America's major employers on retirement issues, the ERISA Industry Committee ("ERIC") appreciates the Committee's focus on retirement security. Thank you for the opportunity to submit this statement for the record for the Committee's Retirement Savings 2.0: Updating Savings Policy for the Modern Economy hearing.

ERIC'S INTEREST IN RETIREMENT PLANS

The ERISA Industry Committee ("ERIC") is a nonprofit association committed to the advancement of the employee retirement benefit plans of America's largest employers. ERIC's members provide comprehensive retirement benefits to tens of millions of active and retired workers and their families. ERIC is committed to preserving and enhancing the voluntary employer-provided retirement system and the tax incentives that support it.

SUMMARY OF COMMENTS

ERIC recommends that Congress consider the following with respect to retirement plans.

- The current employer-based retirement system benefits workers by providing workers with protections, while facilitating retirement savings.
- The voluntary employer-based retirement plan system allows companies to attract and retain quality workers, while giving companies the flexibility they need.
- Congress should protect the tax incentives that help workers to save for retirement.

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OVERVIEW

As we celebrate the 40th anniversary of the Employee Retirement Income Security Act of 1974 (“ERISA”), we should reflect on the successes of the voluntary employer-sponsored retirement system. The current employer-sponsored retirement plan system allows tens of millions of American workers to save for retirement. The U.S. Department of Labor reports that in 2011, private companies sponsored over 680,000 retirement plans and nearly 130 million Americans participated in retirement plans.¹

Large companies voluntarily establish retirement plans and encourage their employees to participate in order to help them adequately prepare for retirement. According to the Bureau of Labor Statistics, 89% of employees at companies with 500 or more employees have the ability to participate in an employer-sponsored retirement plan.²

The Government Accountability Office (“GAO”) included a summary of some of the benefits of employer-sponsored retirement plans in a recent report. The GAO explained that retirement plans “generally [have] lower fees, better comparative information, and ERISA plan fiduciaries are required to select and monitor reasonable investment options.”³

Congress has also repeatedly recognized the value of the retirement plan system. For example, in 2012, over 100 members of Congress introduced a resolution seeking a “Sense of Congress” that the current tax incentives for retirement plans should be maintained.⁴

As the Committee on Finance considers tax reform, we urge the Committee to recognize the value of the tax treatment of retirement savings and the benefits it provides to millions of workers and their families. Employer-sponsored retirement plans help millions of American families achieve a secure retirement. We believe that it is important to distinguish a tax deferral from a tax exclusion or deduction. Unlike a tax exclusion or deduction, tax deferral in retirement plans increases taxes paid when the taxpayer takes a distribution from the plan. Not appreciating this distinction can lead to unintended policy decisions. We urge the Committee on Finance to preserve the current tax treatment for retirement plans that encourages employers to offer and workers to contribute to these plans.

¹ U.S. Dep’t of Labor, *Private Pension Plan Bulletin: Abstract of 2011 Form 5500 Annual Reports* (Jun. 2013).

² Bureau of Labor Statistics, *Table 1. Retirement benefits: Access, participation, and take-up rates* (March 2014).

³ Gov’t Accountability Office, *GAO-13-30: 401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants* (Mar. 7, 2013), available at <http://www.gao.gov/products/GAO-13-30>.

⁴ H.Con.Res. 101, Expressing the sense of the Congress that our current tax incentives for retirement savings provide important benefits to Americans to help plan for a financially secure retirement, 112th Congress, 2d Session (Feb. 16, 2012).

DETAILED COMMENTS

I. The current employer-based retirement system benefits workers by providing workers with protections, while facilitating retirement savings.***A. The current system encourages companies and employees to jointly work towards preparing workers for retirement.***

The current employer-provided retirement system encourages workers to save for retirement, while providing companies with the means to attract and retain employees. Access to a mechanism to save is critical to facilitate individuals' saving for retirement. As indicated above, companies sponsor hundreds of thousands of retirement plans which provide millions of participants with retirement income. In addition to employer retirement contributions, the vast majority of these plans also allow workers to contribute towards their retirement savings. Companies can adopt defined benefit plans and/or hybrid plans, where the employer typically funds the benefit; as well as defined contribution plans, where both the plan sponsor and the employees can contribute. Congress has also established nondiscrimination rules, which ensure that employer contributions to plans are distributed among the vast majority of workers.

The retirement plan system has been successful at providing retirement benefits to all workers and in particular, moderate-income workers. According to the Employee Benefit Research Institute ("EBRI"), over 70 percent of workers making between \$30,000 and \$50,000 save when covered by a workplace savings program, whereas less than 5 percent of those same workers save on their own when not covered by a plan.

B. Participants benefit from the flexibility the current system affords them to save more when they are able to do so.

The current retirement system works well by providing workers with the flexibility they need, when they need it. Employees need the flexibility to be able to save more when they are able and contribute less when they are under financial constraints. For example, an individual may be able to save more when they are younger or once their children become adults, but have less money to contribute when paying for their children's college education or caring for their elderly parents.

The system that Congress developed allows employees to make elective deferrals up to \$17,500 per year and up to \$23,000 for workers age 50 and older. By adopting this approach, Congress recognized the need for older workers to be able to save more as they are nearing retirement.

As a result, it is critical that Congress recognize the value of the current system that reflects typical lifetime savings habits and maintain the elective deferral limits.

C. Congress also enacted laws that ensure that companies properly administer retirement plans.

Employees benefit from the important services provided by the fiduciaries of retirement plans. These fiduciaries ensure that the plan is well-run by selecting quality investment alternatives, monitoring plan fees, and choosing high quality service providers.

Furthermore, ERISA requires fiduciaries to act solely in the interests of plan participants. These fiduciaries are required to operate retirement plans in accordance with the highest standards known to the law. They are also held to the standard of a prudent person, acting in similar circumstances. As a result, the interests of participants are well protected.

D. Retirement plans are portable and transparent, which allows workers to understand their benefits and take those benefits with them when they change jobs.

Data shows that American workers frequently change employers. The median tenure for wage and salary workers was around 5.5 years in 2012.⁵ As a result, flexibility is a key component for workers to obtain adequate retirement savings. Flexibility also allows companies to design plans that work effectively and efficiently based on the needs of their workforces and the industries in which they operate. As a result of this flexibility, employers can offer generous benefits based on their particular situations.

Defined contribution plans are also highly portable so workers can take their defined contribution plan assets with them when they change jobs. Congress has enacted laws that allow workers to roll their retirement plan benefits into IRAs or, in many circumstances, into other qualified retirement plans.

Rules and regulations also require a high level of transparency so that employees receive regular disclosures about their retirement savings plans that indicates that their employers are administering their retirement plans prudently and in the best interests of the participants.

E. Congress and the government agencies have instituted measures to ensure that the interests of participants and plan sponsors are balanced.

The current retirement system involves a delicate balance between the needs of participants and the companies that sponsor their retirement plans. Several government agencies, including the U.S. Department of Labor, Treasury Department, and Pension Benefit Guaranty Corporation, have the responsibility of protecting participants and their retirement savings. They issue detailed regulations and guidance to ensure that participants' interests are well-protected. For example, there are rules regarding vesting, coverage, and the allocation of benefits in retirement plans. Congress also oversees, and frequently revises, the rules for retirement plans.

F. Congress should protect the interests of workers by maintaining the current employer-based retirement plan system.

ERIC urges policymakers to protect retirement plans and the workers who participate in them by maintaining the current rules. Over time, Congress has enacted laws that maximize the benefits of the retirement plan system while minimizing potential concerns. This system encourages companies and workers to jointly help employees save for retirement and ensures that plans are properly administered. These laws, and their corresponding regulations, have also resulted in portable and transparent retirement plans which balance the needs of employers and employees. As a result, it is critical that Congress protect the valuable system that it has created.

⁵ Employee Benefit Research Institute (EBRI), *Employee Tenure Trends, 1983–2012* (Dec. 2012).

II. The voluntary employer-based retirement plan system allows companies to attract and retain workers, while giving them the flexibility they need.

The voluntary employer-based system also allows companies to use retirement plans as a means to compete for quality workers, to keep those workers, and to ensure that they can retire from their workplace with adequate retirement savings.

The voluntary nature of the private sector retirement system is critical to its success. The diverse nature of employers necessitates a flexible retirement system. Some companies employ only a handful of workers, while others have over a million employees. Some employers have workers all over the globe, while others are regionally based. As a result, a “one-size-fits-all” approach to retirement plans often will not address the challenges of companies who want to offer retirement benefits to their workers. For example, some workforces may prefer defined benefit plans based on the needs of the employees, while other workers may prefer to participate in 401(k) plans.

Flexibility fosters creativity in plan design and enables companies to implement innovative approaches to promote participation, increased deferrals, and appropriate investment of contributions. These ideas often lead to overall improvement in the retirement plan system.

Flexibility is also critical in times of uncertainty. For example, some companies faced financial difficulties during the recent recession and had to stop making matching contributions to their 401(k) plans. Many plans made these decisions based on limited cash flow realities and decided to temporarily reduce retirement benefits while saving company jobs. When profitability returned, these plans were able to resume their contributions and the number of plans making matching contributions is back to pre-recession levels. If rules are too stringent and inflexible and do not allow for employers to respond to rapid economic changes in the best interest of their workforce, it will undoubtedly lead to decisions that undermine the U.S. economy and workforce. Anecdotal evidence reflects that many workers strongly supported their companies’ decisions to provide a temporarily lower company 401(k) match in order to save jobs.

Flexibility is particularly crucial with respect to the funding of defined benefit plans. Companies may be highly profitable in some years and less so in other years. They need to be able to contribute more to their retirement plans when they are financially able and obtain relief during the years when it is needed. As a result, the funding rules associated with defined benefit plans should be reasonable, consistent and allow appropriate flexibility while maintaining high fiduciary standards and responsible financial commitments. Defined benefit plans involve long-term liabilities – over 20, 25 to 30 years. Common-sense funding rules are imperative to address the pressures of changing economic conditions and the growing competition by international companies.

Flexibility is also important for the maintenance of frozen defined benefit plans. Plan sponsors often grandfather some or all of the existing employees in a plan when it freezes its defined benefit plan for some existing or new employees. These grandfathered employees continue to accrue benefits under the plan and are very helpful to the older longer service employees who often have made retirement plans based on the benefit formula previously in effect.

Over time, however, these arrangements can cause nondiscrimination testing problems when workers in the plan often typically become higher earners and no new lower paid workers are

included in the plan for testing purposes. The most workable solution to this problem in many cases is to (1) remove some or all of the longer service (and perhaps more highly compensated) employees from the defined benefit plan, or (2) more likely, completely freeze the defined benefit plan. This can result in participants losing the most beneficial years of pension plan participation. Although the Treasury Department has issued temporary relief for defined benefit plans that provide ongoing accruals, the relief will apply only to a limited number of plans.⁶

ERIC strongly encourages Congress to continue to encourage companies to voluntarily sponsor retirement plans, by including reasonable flexibility in any changes to the rules for retirement plans.

III. Congress should protect the tax incentives that help workers to save for retirement.

A. The deferral nature of retirement plans allows Congress to promote retirement savings at a reduced cost.

Historically, Congress has supported, on a bipartisan basis, tax incentives that help support the employer-based retirement savings program. It is important to note that in retirement plans, taxes are merely deferred for retirement plan contributions until the employee receives the funds (which is typically during retirement). Thus, tax revenue is not lost when workers contribute to their retirement accounts, it is merely *delayed* until the worker retires and begins taking distributions. This differs from tax expenditures where the tax is completely avoided (i.e., deductions).

Congress should recognize that the deferral nature of retirement savings is not properly reflected in the calculations performed by the Joint Committee on Taxation (“JCT”) and the Treasury Department. These calculations do not consider that there is only a deferral of taxation when they measure the cost of the tax deferrals into retirement plans, such as 401(k) plans. The majority of the taxes paid show up outside the 10-year time frame used by the JCT and Treasury Department because workers generally withdraw money from these plans only in retirement. The majority of the costs for deferrals are “scored” as lost revenue, instead of being reflected as deferred revenue. This approach significantly exaggerates the actual cost to the government for the tax incentives for retirement plans and ignores the real long term value of the plans to the country and working Americans.

This approach could also damage the long-term solvency of the government. If Congress acts upon these measurements, the amount of funds the government will receive when the money was scheduled to be received (i.e., when participants retire) could be significantly reduced. It is critical that Congress recognize that retirement plan contributions are deferrals, not deductions, when evaluating the tax provisions related to retirement plans.

⁶ See, ERIC Comment Letter to IRS, *Notice 2014-5 - Nondiscrimination Relief for Closed Defined Benefit Plans* (Feb. 28, 2014), available at <http://www.eric.org/uploads/doc/retirement/ERIC%20Comment%20Letter%20on%20Notice%202014-5.pdf>.

B. Proposals to change the current retirement plan system would have significant negative consequences.

Congress has indicated that it is considering making changes to the tax system. We urge the Committee to recognize that the current U.S. employer-sponsored retirement plan system is designed and structured to carefully balance the interests of employers and employees.

Various proposals have been offered in the context of claiming to “improve” the current retirement system or reduce the federal budget deficit.⁷ Generally, these proposals would limit the amount that could be contributed to a retirement plan, replace the current deferral of contributions with a credit, or limit the value of the retirement benefit. However, research reflects that these proposals would reduce retirement security for workers at all income levels, not just high-income workers.⁸ For example, the study revealed that some employers would decide to no longer offer a plan to their workers and some participants would decrease their contributions under the proposals. The combined effect of these changes could result in reduced retirement savings of between 6 and 22 percent for workers currently age 26-35, with the greatest reductions for those in the lowest income quartile. Lowest-income participants in retirement plans with less than \$10 million in assets could see reductions as high as 40 percent.

Additionally, the President has repeatedly proposed changes to the system that would limit the amount American workers could save for retirement.⁹ This would negatively impact the amount Americans save for retirement. For example, there were significant negative consequences in the 1980s when Congress limited retirement contributions. When the eligibility requirements for individual retirement accounts (“IRAs”) were complicated, deductible contributions declined from \$37.8 billion in 1986 to only \$14.1 billion in 1987 and continued to steadily decline thereafter.¹⁰ Workers have shown that they will save less when there is increased complexity in retirement plans.

We urge Congress to be wary of unintended consequences. Changes to the rules for retirement plans often result in a “chilling effect” on savings even by individuals who are *unaffected* by the rules change. Congress should take into account all the factors that contribute to a healthy and successful private sector retirement system. In the above IRA example, policymakers underestimated the role financial services companies played in encouraging IRA contributions. When everyone could make a deductible IRA contribution, banks and other institutions would take out full page ads in newspapers to remind and encourage individuals to make their annual IRA contribution. When the rules changed and became too complicated to explain, the advertisements disappeared and so did the IRA contributions.

⁷ EBRI, *Modifying the Federal Tax Treatment of 401(k) Plan Contributions: Projected Impact on Participant Account Balances* (Mar. 2012), available at http://www.ebri.org/publications/notes/index.cfm?fa=notesDisp&content_id=5019.

⁸ *Id.*

⁹ The White House, *The President's Budget for Fiscal Year 2015*, available at <http://www.whitehouse.gov/omb/budget>.

¹⁰ Sarah Holden, Kathy Ireland, Vicky Leonard- Chambers, and Michael Bogdan, *The Individual Retirement Account at Age 30: A Retrospective*, The Investment Company Institute, available at <http://www.ici.org/pdf/per11-01.pdf>.

Additionally, workers significantly value the ability to contribute to their 401(k) plans on a pre-tax basis.¹¹ Over 89 percent of people surveyed by EBRI indicated that the ability to contribute to a retirement plan on a tax-deferred basis was somewhat or very important to them.

ERIC urges Congress to recognize that any changes to retirement savings incentives must focus on policy that will result in better long-term retirement outcomes for Americans, rather than on short-term deficit reduction.

CONCLUSION

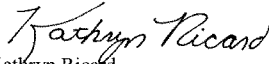
The current structure for employer-provided retirement plans is a key component of the successful U.S. retirement system. Our current system helps working Americans at all income levels build resources for a financially secure retirement. Changing the current tax treatment of employer-sponsored plans could have a significant negative impact on Americans' retirement readiness. It could jeopardize the retirement security of tens of millions of workers, impact the role of retirement assets in the capital markets, and create challenges for future generations of retirees in maintaining their quality of life.

The current retirement system works well for both companies and workers by carefully balancing their needs. Retirement plan rules ensure that plans treat participants fairly and without discrimination (e.g., the vesting, coverage, and nondiscrimination rules) while encouraging employers to voluntarily sponsor the retirement plans that benefit their workers.

Congress should protect the retirement system to allow future generations to prepare for an adequate retirement. ERIC urges Congress to exercise significant caution when considering any changes to the tax incentives relating to the retirement system and avoid major unintended adverse consequences.

ERIC appreciates the opportunity to provide comments on tax reform. If you have any questions concerning our comments, or if we can be of further assistance, please contact us at (202) 789-1400.

Sincerely,


Kathryn Ricard
Senior Vice President, Retirement Policy

¹¹ EBRI, *Tax Reform Options: Promoting Retirement Security* (Nov. 2011), available at http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=4934.

**Statement for the Written Record of the United States Senate Committee on Finance's
September 16, 2014 Hearing, Retirement Savings 2.0: Updating Savings Policy for the
Modern Economy.**

This statement for the record of the Committee on Finance's hearing, Retirement Savings 2.0: Updating Savings Policy for the Modern Economy, is submitted by J. Michael Keeling, President of The ESOP Association, 1726 M Street, NW, Suite 501, Washington, DC 20036.

The ESOP Association is a 501(c)(6) under the Internal Revenue Code, also referred to as a business trade association.

This statement is submitted on behalf of the over 1,500 U.S. member corporations, located in all 50 states, that sponsor an employee stock ownership plan, or ESOP, sanctioned by the provisions of ERISA, both the tax provisions and the retirement provisions, which as highlighted by the hearing, was signed into law 40 years ago. The ESOP Association also has over 1,000 professional members, woman and men, who provide services specific to the laws and regulations that must be obeyed to be tax qualified deferred compensation plans.

As the Committee members know, ERISA sanctions the basic tax qualified deferred compensation plans whose purpose is to provide individuals participating in the plans with retirement income.

The two general types of ERISA plans are defined benefit plans or deferred compensation plans.

An ESOP, by law, must be primarily invested in the highest class of stock of the plan sponsor and the stock may be acquired with borrowed funds. In practical terms, the plan sponsor may take on 'debt' to acquire shares of the sponsor, and not be engaged in a prohibited transaction if the shares are acquired by the ESOP trust at a price no greater than the fair market value.

The Joint Committee on Taxation, Document JCT 98-14, pages 5, 6, 21, 30-33, provide, as expected, an excellent description of the unique aspects, approved by Congress, of employee stock ownership plans, or as commonly referred to, "ESOPs."

Brief Historical Overview

The ESOP model of employee ownership actually has its roots in a deferred compensation practice from the 19th Century. (A recent book, **The Citizen's Share**, Blasi, Freeman, and Kruse, Yale Press, wrote very a convincing case in pages 1 – 56, that our founding fathers, such as Washington, Jefferson, Adams, Hamilton, et al, believed in broad ownership of productive assets as being essential to the survival of a democracy. President's Lincoln's views, as evidenced by the Homestead Act, were also in sync with these views.)

As the U.S. economy moved into the industrial age, corporations with nationwide reach, and large numbers of employees emerged — Procter & Gamble, Montgomery Ward, and others.

Leaders of these companies realized that some employees would work for many years, reach an age requiring retirement, and retire with no income. There was no 19th Century safety net for retirees, and leaders of a number of national firms decided to set aside company stock for the employees to have when they retired, and to “cash in.”

After World War I, and the ratification of the 16th Amendment to the Constitution authorizing a national income tax, the Ways and Means Committee recognized that taxing income was not so simple, and that many issues had arisen because the basic definition that income is anything of value received by an individual, and the general rule that an income tax should tax anything of value.

In response to questions of what income should be taxed, the Ways and Means Committee developed the very first true income tax code, the Code of 1921.

In developing the Code, those firms that were setting aside stock for their retiring employees came to the Ways and Means Committee and asked — is the stock to an employee taxable when set aside? Is the value of the stock an employer’s compensation cost?

The Ways and Means Committee decided no, it was not current income to the employee, but would be taxed when the employee realized the previously deferred income; and yes, the set aside was compensation, and thus a cost of business for the employer and thus deductible for income tax purposes.

Thus, the first deferred compensation plan recognized by the Ways and Means Committee was the “stock bonus plan,” the forerunner of today’s ESOP.

Fast forward to post War World II and owners of privately-held businesses began to consider how to “exit” their businesses and “cash” in their non-tradable stock in the company they started and which become successful because of the hard work of the company employees. While somewhat lost in history due to the fact that until the mid-1970s private letter rulings were not public documents, an owner in Alaska, followed by others, obtained permission from the IRS, in a non-public letter ruling, that the company could “buy” the stock with borrowed money from the current owner of the private company, have the stock placed in the stock bonus plan, and allocated to the employees as the debt was paid off.

A true visionary in San Francisco, California, Dr. Louis O. Kelso, developed a comprehensive economic philosophy in using such a method for funding stock bonus plans, and to expand ownership in a capitalistic society. He and his law firm colleagues led the way in expanding the use of this method blessed by the letter rulings, and many correctly note that the first “ESOP” was the sale by exiting shareholders of the *Monterrey Press* in 1957 to an ESOP.

Meanwhile, the world of deferred compensation plans ballooned, especially during World War II, when there were wage and price controls to make sure our nation defeated Fascism and Nazism.

By the mid-1950s, many, both conservative and liberals, were seeing abuses in the area of pensions, or tax qualified deferred compensation plans, which the tax laws sanctioned and encouraged. Evidence was overwhelming that some pension funds were investing in organized crime activities. Then there was the collapse of major U.S. employers, leaving employees with no retirement income as promised — the Studebaker Corporation probably had the most media notice. As a result, a drive in Congress to “reform” the tax and labor laws governing tax qualified deferred compensation plans, or “retirement savings plans,” led to the enactment of ERISA in 1974.

During Congressional work on these “tax qualified deferred compensation plans,” a major influence on tax policy of that era, Senator Russell B. Long, long time chair of your Committee on Finance became a champion of the economic philosophy of Dr. Kelso, and made sure the new ERISA law sanctioned ESOPs.

His support for the ESOP model grew stronger with each passing year, and his leadership led to major enactment of tax laws promoting the creation and operation of ESOPs. The bulk of these laws passed in 1984, in legislation referred to as DEFRA, and the perfection of those laws was in the Tax Reform Act of 1986. Many of these laws of the 1980s remain in the Code, and were evidenced and endorsed repeatedly by the Finance Committee members in hearings, and tax law legislation of the late 80s through the late 90s, even after Senator Long retired in 1987.

To be noted, a major partner with Senator Long promoting ESOPs in the 80s through 1988, was former President Ronald Reagan, who often spoke of his view that widespread ownership of productive assets was the core of maintaining equitable wealth ratios in a capitalistic society.

And, after Senator Long retired, his successor in the Senate, John Breaux, led to the expansion of ESOP law in the 1996-1997 tax bills permitting S corporations to sponsor ESOPs. Since Senator Breaux’s work to expand ESOPs, the number of 100% ESOPs that are S corporations has exploded, many of these employees are now the basic owners of the corporation. (There are out of the estimated 10,000 ESOP companies, an estimated 3,000 are 100% ESOP.)

In sum, the work you are doing is part and parcel of a long, supportive policy of the Finance Committee developing laws to have average pay employees, or workers if you will, be owners as being good for the employees, good for their employer, and good for the wellbeing of our democracy.

Intent of Promoting ESOPs

Clearly, Congress, in sanctioning ESOPs, intends for ESOPs to provide the employees/ participants, or their survivors, wealth for use during the years that s/he no longer works, due to retirement, disability, or death.

Thirty-six plus years of data by reputable experts in retirement savings is very convincing that ESOPs provide, in the vast majority of instances, assets that are better than other employer sponsored retirement plans. (See the attachment to this document summarizing and citing a few of these studies about the retirement benefits provided to employees participating in an ESOP.)

In brief, data in some instances have the average ESOP account balance at nearly \$200,000 per participant compared to the \$75,000 range of other defined contribution plans. Even more impressive is studies indicate that it is the nature of most employers that sponsor an ESOP to have an additional retirement savings plan for its employees, usually a 401(k) plan, whereas sadly over half of American employees have no, none, zero, retirement savings plan where they work.

(Please note, researchers are bedeviled trying to pin point the precise value of an individual's account in a defined contribution plan, as the only required data from companies is provided on the IRS Form 5500, which gives a "gross" value of the plan, that more often than not gets divided by the total number of employees in the plan, meaning employees working two or so years with small balances bring down the average balances which are better measured by the number of years, and age of the employee participants. There are a variety of research methods used, none generally accepted as "fool proof" to adjust for this lack of data, that adjusts for the gross average of plan accounts. In any event, what there is, for better or worse, makes a convincing case that ESOPs provide excellent benefits for retirement security in the vast majority of instances.)

But the history of Congress's endorsing and encouraging ESOPs demonstrates other intents for encouraging ESOP creation and operation.

None of these other intents distracts from the intent that ESOPs provide adequate retirement income for employees participating in the ESOP, and in fact, when met, all of these other intents result in the employees having more retirement income security than those not participating in an ESOP.

To explain, Congress has indicated that it intends ESOPs, a model of employee ownership, to result in "better" companies, which can be defined as being more productive, more profitable, with more sustainable jobs, with less turnover, and layoffs. In such a company, obviously, the underlying value increases, thus increasing retirement value of having the ESOP payout based on the share value of the company stock, the primary asset of an ESOP.

While the attachment summarizes the data that in the vast majority of instances, ESOP companies are more productive, more profitable, and provide more sustainable jobs, just one specific note in the body of these comments must be shared.

The General Social Survey of 2010, conducted by an affiliate of the University of Chicago, evidences that during the Great Recession, employee stock owned companies in the U.S., which are primarily ESOP companies, laid off employees at rate of less than 3%, whereas conventionally-owned companies laid off employees at a rate of over 12%.

Another intent clear in the history of Congressional work on ESOP law is that it is a method that "finances" average income Americans becoming part of a capitalistic economy, which by far and away, when successful, benefits more citizens than any other form of economy. See Pub. L 94-455 Section 803, also attached, setting forth in law Congressional intent with regard to ESOPs and financing. (The major theme of the earlier mentioned book, **The Citizen's Share**.)
(Attachment 2)

In reviewing the demographics of ESOPs, which are really not that numerous in America in comparison to the number of operating businesses that actually have payroll, it is clear that this intent has been met as most ESOPs are privately-held companies that were created to benefit employees when the owner[s] of a private company “exit” the company that she or he lead by selling shares to an ESOP, versus selling to outside investors, a competitor, a few senior managers, or even just liquidating his/her company. (By the way, these non-ESOP “exit” strategies often lead to employee layoffs.)

A final intent is one that has not been reached, only because there are not enough “owners” of productive assets by average pay Americans. It is this intent that drove the originator of the ESOP concept, California lawyer Dr. Louis O. Kelso to proselytize for employee stock ownership with a dedication and tenacity seldom seen, and which persuaded the beloved, and masterful legislative master the late Senator Russell B. Long, to begin the development and nurturing of laws to encourage ESOP creation and operation.

The intent, to limit and even prevent, the concentration of wealth in a capitalistic society where the wealth gap between the top 1% and average pay employees gets bigger and bigger; but more important, income disparity in the extreme can lead to social disorder, and less individual freedom can lead the majority to seek government intervention to create a “fair” society which in turn, can lead to less individual freedom and opportunity.

Bluntly, there are not enough citizens that have been “financed” into ownership positions to claim that this intent for widespread ownership through ESOPs has been met on a large scale. But where the ESOP does exist, data is very clear that average pay participants’ total wealth is not so small compared to the top income people in society.

Brief Description of Special Tax Laws Applied to ESOPs

The special tax laws that encourage the creation and operation of ESOPs are basically deferral oriented tax law provisions: (1) The owner of a non-publicly traded C corporation may sell her/his stock to an ESOP, and if the ESOP owns 30% or more of the corporation sponsoring the ESOP after the close of the sale, the seller may defer his/her capital gains tax until he or she disposes of U.S. securities acquired with the proceeds from the sell to the ESOP; (2) employees of an S corporation that sponsors an ESOP are not taxed on the income of the S corporation on a yearly basis, as legally the tax exempt ESOP trust holds the shares, but when an employee receives a distribution from the ESOP, s/he pays taxes on the cash value of the shares, which clearly are valued based on the income of the S corporation over the years; and (3) dividends paid on ESOP stock are deductible by the ESOP sponsor if the dividends are paid to employees in cash — clearly taxed to the employee, used to pay the debt the ESOP incurred to acquire the employer’s stock, or is reinvested in more shares of the sponsoring corporation.

Note, the deferral of capital gains upon sale of stock to an ESOP by a current owner, and the deduction of the value of dividends on ESOP stock, under certain terms, are not available to S corporations.

Also note that some commentators suggest that the ability of a C corporation to deduct the principal and interest of a loan used by the ESOP to acquire its primary asset, plan sponsor stock, is a special tax rule for ESOPs. Other commentators argue that arranging corporate affairs to match contributions to an ERISA plan equal to corporate debt is available to any corporation with an ERISA plan and under current law any corporate interest on corporation debt is deductible. This view holds the “P&I” deduction ESOP sponsor can take is not really a special treatment of ESOP companies.

And obviously, as an ERISA plan, an ESOP sponsor may deduct the value of contributions to the ESOP, but this tax treatment is not unique to ESOP contributions.

Very important is the Congress, again led by the Senate Finance Committee, has now placed in law very thorough requirements that must be met before these benefits are available, especially with regard to S corporation ESOPs.

Summary

The Senate Finance Committee has a long history of supporting laws that encourage the creation and operation of ESOPs because in the vast majority of instances, ESOP companies are more productive, more profitable, with sustainable jobs for their employees that are locally-controlled, while providing retirement benefits that are greater than most U.S. conventionally-owned companies.

Attachment 1

Employee Ownership & Corporate Performance

1. Using data from the 2010 General Social Survey (GSS), an analysis by the National Center for Employee Ownership (NCEO), in partnership with the Employee Ownership Foundation, evidences that employee stock owned companies saved the federal government over \$23.2 billion in 2010, a year of high unemployment. How? During the Great Recession of 2010, employees of employee stock owned companies were laid off at a rate more than 4 times less than employees of conventionally-owned companies. The 2010 GSS showed that employee stock owned companies laid off employees at a rate of 2.6% in 2010, whereas the rate for conventionally-owned companies was 12.1%.

1.a. The National Center for Employee Ownership analysis calculates that 18 million Americans worked for employee stock owned companies in 2010, with 11 million working in companies with employee stock ownership plans, or ESOPs. Savings from the low layoff rate of ESOP participants was \$14.5 billion in 2010, or seven times more than the estimated \$2 billion a year tax expenditure attributed to the special laws promoting ESOP creation and operation.

To view additional comments about the research, please visit The ESOP Association's YouTube Channel - <http://youtu.be/Eb9vaoHqzHg>. The full analysis can be found <http://www.esopassociation.org/docs/default-source/press-release-docs/here.pdf?sfvrsn=0>.

2. In the book, *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-Based Stock Options*, edited by Douglas L. Kruse, Richard B. Freeman, and Joseph R. Blasi, the editors list some take away findings on shared capitalism. The book identifies employee stock ownership plans (ESOPs) as a primary model of shared capitalism in the U.S. Below are the summarized findings.

- Shared capitalism is a significant part of the U.S. economic model. Shared capitalism can increase wealth for workers at lower and middle income levels.
- Shared capitalism improves the performance of firms. It is associated with greater attachment, loyalty, and willingness to work hard; lower chance of turnover; worker reports that co-workers work hard and are involved in company issues; and worker suggestions for innovations. Shared capitalism is most effective when combined with employee involvement and decision-making and with other advanced personnel and labor policies.
- Shared capitalism improves the performance of worker well-being. It is associated with greater participation in decision-making; higher pay, benefits, and wealth; greater job security, satisfaction with influence at the workplace, trust in the firm, and assessment of management; and better labor management relations practices. Shared capitalism is most effective when combined with employee involvement and decision-making and with other advanced personnel and labor practices.
- Shared capitalism complements other labor policies and practices. Firms with shared capitalism compensation are more likely to have other worker-friendly labor policies and practices. Combinations of shared capitalist pay and other policies, such as devolving decision-making to employees, wage at or above the market rate, and lower supervisory monitoring, produce the largest benefits for workers and firms.
- The risk of shared capitalism investments in one's employer is manageable. Portfolio theory suggests employee ownership can be part of an efficient portfolio as long as the overall portfolio is properly diversified. Most workers have modest amounts of employee

ownership within the ranges suggested by portfolio theory. Less risky forms of shared capitalism such as cash profit sharing and stock options where workers are paid market wages, or company stock is not financed by worker savings, can be prudently combined with riskier forms where workers purchase stock.

Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-Based Stock Options, edited by Douglas L. Kruse, Richard B. Freeman, and Joseph R. Blasi, The University of Chicago Press, National Bureau of Economic Research, 2010. Above information can be found on page 12.

3. In the summer of 2014, the Employee Ownership Foundation released results from the 23rd Annual Economic Performance Survey (EPS) of ESOP companies. Since the Employee Ownership Foundation's annual economic survey began 23 years ago, a very high percentage, 93% of survey respondents, have consistently agreed that creating employee ownership through an ESOP was "a good business decision that has helped the company." It should be noted that this figure has been over 85% for the last 14 years the survey has been conducted. In addition, 76% of respondents indicated the ESOP positively affected the overall productivity of the employee owners. In terms of revenue and profitability --- 70% of respondents noted that revenue increased and 64% of respondents reported that profitability increased. In terms of stock value, the majority of respondents, 80%, stated the company's stock value increased as determined by outside independent valuations; 18% of the respondents reported a decline in share value; 2% reported no change. The survey also asked respondents what year the ESOP was established. Among those responding to this survey, the average age of the ESOP was 16 years with the average year for establishment being 1998.

4. Also in September 2010, the Employee Ownership Foundation released the results of an extensive study it funded that evidenced that ESOPs provide more employee benefits than non-ESOP companies. The study, which reviewed data from the Department of Labor Form 5500 on defined contribution retirement plans, found:

- ESOP companies have at least one plan, the ESOP, but more than half (56%) have a second retirement savings/defined contribution plan, likely a 401(k) plan. In comparison, the Bureau of Labor statistics reports that 47% of companies have some sort of defined contribution plan which shows that an ESOP company is more than likely to have two defined contribution plans than the average company is to have one plan.
- The average ESOP company contributed \$4,443 per active participant; in comparison to a non-ESOP company with a defined contribution plan which contributed on average \$2,533 per active participant. This study found that on average ESOP companies contributed over 75% more to their ESOPs than other companies contributed to their primary plan.

The project was done by the National Center for Employee Ownership (NCEO).

Attachment 2**This Is The Law!**

90 Stat.1520, P.L. 94-455 Section 803

(h) Intent of Congress Concerning Employee Stock Ownership Plans. -- The Congress, in a series of laws (the Regional Rail Reorganization Act of 1973, the Employee Retirement Income Security Act of 1974, and the Tax Reduction act of 1975) and this Act has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trust and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans. (Pub. L. 94-455, 90 Stat. 1520)

Statement for the Record of the U.S. Senate Committee on Finance
Robert L. Reynolds, President and CEO, Great-West Financial and Putnam Investments
Hearing on “Retirement Savings 2.0: Updating Savings Policy for the Modern Economy”

September 16, 2014

Introduction

All of us concerned with the issues of savings, economic growth and retirement security should commend Chairman Ron Wyden, ranking member Orrin Hatch and the members and staff of the Senate Committee on Finance for addressing issues vital to America’s future and to the lives of working Americans and their families.

As President and CEO of America’s second largest retirement services provider as well as one of its leading asset managers and insurance providers, I am honored to have this chance to share our views on these issues with the Committee and the American people. I hope today’s hearing will spur continued debate and lead to effective action -- soon.

The linkages between tax policy, retirement savings, investment and growth are powerful. They should be viewed, together, in the broad context of national economic policy and through an accurate long-term budget lens. And then we should take on these very serious challenges with a spirit of optimism and bipartisan collaboration, because, as I will suggest, America’s existing public-private retirement system provides us with a very strong base to build on. We do face a tough challenge. We don’t face a “crisis.” And the good news is that the key structural elements needed to solve America’s retirement challenge are right before our eyes.

Before discussing those solutions, I would like to briefly mention the larger economic context for retirement policy and the need for a more accurate “lifecycle” accounting for retirement savings incentives.

The Macroeconomics of Savings Policy

Far too often, discussions of American retirement savings fail to place the issue in the context of the larger national economy. Basic economics and our own national experience shows us that retirement savings channeled through robust capital markets are essential to spurring faster overall economic growth. To illustrate that often overlooked fact, Putnam Investments partnered earlier this year with Oxford Economics on a study called Another Penny Saved which analyzed the economic impact of higher household savings in America.

Putnam's co-sponsors on that study included an extraordinary group of retirement associations, financial service firms and civic groups representing more than 80 million Americans. They include AARP, the American Society of Pension Professionals & Actuaries, the Aspen Institute, Bank of America- Merrill Lynch, the Financial Services Roundtable, John Hancock Financial, LPL Financial, Natixis Global Asset Management, the New England Council, and the U.S. Chamber of Commerce.

The study's findings were crystal clear: Current American savings rates are too low to ensure dignified retirement for millions of workers. But raising US household savings could add a net \$7 trillion to America's GDP over the next 25 years. In short, any legislative or regulatory action that promises to increase Americans' savings rate would be strongly positive. But any policy shift that undermines incentives or lowers personal savings would be negative -- damaging future economic growth. The full report's detailed findings are available online at *Anotherpennysaved.com*.

I would urge anyone concerned with retirement and savings policy to access this study. Every discussion of retirement savings and tax policies should take account of this macro-economic context. *Another Penny Saved* provides that context.

More Accurate Budget Accounting for Retirement Incentives.

One of the most disturbing elements of the on-going retirement debate in the U.S. is that it is based on demonstrably false premises and faulty methodology. It is as if we were navigating with a broken compass or measuring with a two-foot yardstick.

Three elements of current budget scoring for retirement "costs" are especially egregious and should be questioned and changed before the next round of pension or tax reform legislation goes forward.

First and most importantly, savings "deferrals" should be treated for budgetary purposes as distinctly different from such true "tax expenditures" as deductions for mortgage interest and charitable giving. Savings deferrals are categorically different. Unlike true "once-and-gone" tax expenditures, deferred savings appreciate for many years in vehicles like 401(k)s, IRA's and variable annuities, then flow back into the federal revenue system on withdrawal. At withdrawal, the capital gains and dividends such accounts hold are taxed as ordinary income.

This process unfolds over decades, lifetimes, in fact. So to accurately assess their long-term budget impact we need to adopt a full-lifecycle, holistic time-frame to measure net costs.

Secondly, and almost equally important, The "ten-year window" is a totally inappropriate metric to apply to cash flows that evolve over a half-century or more. It

routinely overstates true revenue “costs” to Treasury of savings deferrals and takes no account of the economic – and human—damage that could be done if savings incentives are cut or curtailed. We need to adopt a much longer “lifecycle” methodology.

Thirdly, in estimating the long-term budgetary cost of savings deferrals, Congress should also include a reasonable estimate for the future savings to Treasury that stem from the fact that these same savings help citizens rely on their own resources – before needing to draw on means-tested federal benefits such as Medicaid. The American peoples’ retirement savings do, in reality, provide a buffer that shields Treasury against the need to fund those citizens’ daily necessities in retirement.

Surely, we can find reasonable ways to estimate these savings when we “score” retirement policy changes.

Personal solvency and national solvency reinforce each other. Policy makers should never pit one against the other.

Recognizing the economic benefit of raising household savings and assessing the true cost of our existing savings incentives can lay a solid foundation for action to strengthen both the public and private elements of America’s “hybrid” retirement system.

The State of Americans’ Retirement Readiness Today

The key policy decisions needed to do that literally “jump out” at us from the annual Lifetime Income Survey (LIS) that Putnam Investments has been doing over the past four years with Brightwork Partners. These surveys take stock of the total assets, savings patterns and retirement readiness of more than 4000 working Americans aged 18 to 65 – weighted to match US census parameters.

The assets we count are comprehensive: Social Security and DB plan benefits, Defined Contribution balances, other savings and investments and even home equity and the value of businesses that people own. We measure retirement readiness in terms of the ability of these Americans to replace their work-life incomes once they decide to retire. And the results suggest a partial success than can -- and should -- be generalized.

Overall, we estimate that working Americans are on track to be able to replace roughly 61% of the income they enjoy during their working careers. That confirms the future risk – for millions – of a serious drop in living standards in retirement – even when we include Social Security. But what’s more important – and positive –

about the survey's findings is the powerful evidence they provide about what is working well in American retirement savings today – under current law and through current workplace savings plans.

George Orwell once said that “Seeing what’s right in front of one’s nose needs a constant struggle.”

And what these surveys show us – right in front of our nose – are the key changes we need to make to create a robust, reliable public-private retirement system that can dramatically raise the prospects for retirement success for all working Americans.

We Can Solve America’s Retirement Challenge

I would like to suggest three basic steps that could largely finish the job of building a much stronger retirement system -- on our existing base. Based on the findings of our 2014 Lifetime Income Survey, we believe that these changes, if fully implemented and adopted over a sustained work-life, could enable nearly all working Americans to accumulate enough savings to replace 100% or more of their pre-retirement income -- for life.

1) The Baseline: Make Social Security solvent for the long term.

To begin with the bedrock: our Lifetime Income Survey shows that Social Security is irreplaceable for low-income families, vital for the middle class, and of real value even for the quite affluent. It is the base on which most retirees’ future incomes – and current savings plans – rely most strongly.

Even for the most affluent quartile in our survey, a group well on track to replace more than 100% of work-life income in retirement, Social Security is projected to provide as much as 25% of their projected retirement earnings. Moving down the income ladder, the share of Social Security as a source for retirement income rises steadily – to over 95% for the least affluent quartile, many of whom lack any access to any retirement savings plans at work.

So it is very disturbing to note that the system’s long-term funding shortfall is already beginning to cast a shadow over Americans’ retirement future. The intermediate projections found in the most recent report of the system’s Trustees suggests that Social Security may exhaust its trust funds by 2033 – leading to a drop of roughly 25% in projected benefits.

This means that millions of middle-aged Americans already face real risks – not in 2033, but right now. For example, a forty-six year old woman who plans to retire at age sixty-five must now consider the risk that if the nation’s leadership does not act to

shore up Social Security, she may endure a sharp drop in benefits just as her planned 2033 retirement date arrives.

That is why a primary goal of retirement policy in America should be to close Social Security's long-term funding gap and make the system solvent. This is an intellectually easy, politically tough, but ultimately solvable challenge.

Unfortunately, every year that goes by without action makes it even tougher. That said, multiple plans to restore the system's long-term solvency have been proposed, most notably by the 2010 Simpson-Bowles and Domenici-Rivlin deficit reduction studies. As those plans showed, Social Security solvency is clearly achievable without absolute dollar cuts for low-income Americans.

Any politically-feasible reform of Social Security will almost surely require some adjustment in future benefit increases plus some additional revenue, most easily achieved by raising the "cap" on FICA payroll taxes to cover 90% or more of Americans' incomes. Reform will take courageous leadership from the White House. And it will surely require both parties to make painful compromises.

But if we hold lower-income Americans harmless, almost any politically feasible reform would be better than today's uncertainty, not to mention the pain that Americans will feel if we kick this can down the road until we're facing an across-the-board cut as the system's trust funds run down. The sooner we act, the less painful reform will be.

But even a solvent Social Security system, vital as it is, only provides us a base to build on, not a solution in itself. Fortunately, though, our existing workplace savings system can step up to supplement Social Security. As former president Clinton might say: there is nothing wrong with the 401(k) that can't be fixed by what's right about the 401(k). Provided, that is, that we move to generalize the best practices made possible by the Pension Protection Act of 2006 – and find ways to extend on-the-job savings options to all working Americans.

2) Adopting What Works – Full “auto” plan design and 10%+ deferrals

In just over three decades since the 1980s, Defined Contribution or DC plans, like the 401(k), have decisively outpaced defined benefit, or DB, structures, passing them in total assets around 1997 and widening that lead ever since. This has had the effect of shifting much of the risk – and responsibility -- for retirement savings – away from institutions and onto individual workers.

And the experience of the first generation of DC savings clearly showed that workers need help, guidance – even guardrails – to assist them in managing these risks. The

goal, ideally, would be to create workplace plan designs that make it easy for participants to succeed – and hard for them to fail.

The Pension Protection Act of 2006 was a huge step forward toward that goal.

The key plan design features that the PPA endorsed include: automatic enrollment, automatic re-enrollment and automatic savings escalation, plus guidance to qualified “default” investment options such as balanced and target-date funds. In addition, and critically, the PPA also offered legal safe harbor against litigation for plan sponsors that offered these design features.

All of these plan design elements take advantage of the single most powerful force in retirement savings: inertia. It is far easier to raise participation and savings rates by simply enrolling workers and lifting their savings – automatically – than it ever was – or ever will be -- to convince them to take those steps through traditional communication and education.

Auto-plan designs essentially simplify what can be a complex “decision tree.” Instead of having to decide to save, then decide to save more, then decide on investments -- and get all of those decisions right -- workers in plans with fully automatic designs are guided to savings levels and choices that will serve them well so long as they don’t deliberately choose to opt out. In effects, that makes success easy and failure hard.

Over the eight years since the passage of PPA, the results have been dramatic.

Auto-enrollment among workplace savings plans in America has risen from just 11% in 2004 to 47% in 2012. The percent of plans offering lifecycle “default” options has surged even more – from 12% to 81% and our Lifetime Income Surveys show vastly superior levels of retirement readiness for Americans whose workplace plans have adopted these “best practice” automatic designs.

LIS data shows that Americans who lack access to savings plans at work are on track to replace just 42% of their incomes once they retire – even including Social Security.

But Americans who are active in workplace savings plans, by contrast, are on track to replace nearly twice as much -- 82% of their pre-retirement income. Those whose plans use both auto-enrollment and automatic savings escalation, are on track to replace fully 85% and 98% of work-life income, respectively. Most strikingly, workers who defer at rates of 10% or more stand to replace fully 111% of their working income once they choose to retire.

That’s success. By any measure. And we’re not talking about some tiny, outlying exception here. We estimate that nearly 33 million individual retirement savers are on this track to success and they come from all income classes not just the well-to-do.

To me, that suggests that we should focus on ways to encourage the adoption of “full-auto” best practices and a system-wide target deferral rate of 10% -- for every workplace plan in America.

Real progress in that direction could be made if relevant committees in the House and Senate would hold hearings in 2015 focused on what is actually working well in America’s retirement system. More education, information and administrative guidance from the Department of Labor together with pressure from peers and competitors might also “nudge” more plan sponsors towards adopting these proven models. We should do all we can to make “full-auto” plan design the norm in American workplace savings for one simple reason: it works and we know it works.

Similarly, the goal of raising deferral rates from the 7% level – to 10% or more -- should also become the industry and policy norm. The reason is very simple. Our lifetime income survey shows that workplace savers deferring 10% or more are on track to replace fully 111% of their pre-retirement income and that, too, is success, by any measure.

When it comes to financing retirements that may last 20 to 30 years or more, no variable is more important than the savings rate itself. It trumps asset allocation, active-versus passive fund choice, security selection and timing – hands down. More is simply more.

One analogy I would suggest for the urgency of moving to full-auto plan designs and higher deferrals -- is to the discovery of a vaccine that can prevent a serious disease. Once medical professionals know that a vaccine works, they feel obligated to try to inoculate as many people as possible. As a financial professional, I also feel obliged to do all I can to advance structures and behaviors that I know can prevent elderly poverty and ensure retirement success.

By the same principle, I would urge policymakers in Congress to find creative ways to close the “coverage gap” – by extending access to savings plans on the job to every worker who pays Social Security taxes.

3) Extending workplace savings coverage to all

We have supported the idea of automatic payroll-deduction IRA’s for several years. As record-keepers for nearly 7 million participants, we know that Auto-IRA’s would actually be quite inexpensive for companies to implement. The concept also offers the only credible savings option for many millions of lower-income and part-time workers. The reason is simple. Very few lower-to-moderate income workers ever save for retirement unless they have a job-based plan.

Data from the National Association of Plan Advisors (NAPA) shows that 71.5% of moderate income workers (those earning between \$30,000 and \$50,000 a year) actually do save for retirement – if, and only if -- they have a plan at work. Among similar workers who lack a plan on the job, just 4.6% take the active step of opening an IRA. That should be no surprise. Regular payroll deduction is *infinitely easier* than any other way of accumulating retirement assets.

Regrettably, though, efforts to enact Auto-IRA legislation have stalled in recent Congresses in large part due to opposition to the very idea of a “mandate.”

But we believe the time is right to revisit the concept and find ways to implement it in law using generous tax credits or other incentives to make it attractive for even very small business to voluntarily adopt auto-IRAs. At the individual worker level, enrollment in such a plan is absolutely not a mandate – provided there is an easy “opt-out.” Let’s recall that most American workers are already subject to a real mandate – the FICA tax. For them, an Auto-IRA would not be a “mandate,” but a choice.

Conclusion

In offering this statement, I hope to broaden the framework of our country’s retirement policy debate, urge Congress to adopt better measures to “score” retirement savings in future budgets and tax reforms and suggest that we do have the means at hand to strengthen both Social Security and our workplace savings systems.

Solving America’s retirement savings challenge is a difficult, but eminently achievable goal. And progress toward that goal would not only generate a great surge in public confidence in America’s ability to shape its future, it would also spur the increased savings needed to get America’s economy growing faster than its debts.

Changes that enhance retirement security and raise savings rates do more than help secure dignified retirements. They also provide the funds needed to fuel robust capital markets and finance investment and job creation. Over the next generation, economic growth itself offers the most effective, least painful solution for America’s debt and deficit challenge.

For all of these reasons, pursuing retirement security for all should become a bipartisan, all-American effort. I hope that today’s hearing takes us one long stride closer to that goal.

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**STATEMENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS
FOR THE HEARING RECORD
OF THE**

**COMMITTEE ON FINANCE U.S. SENATE
ON
RETIREMENT SAVINGS 2.0:
UPDATING SAVINGS POLICY FOR THE MODERN ECONOMY**

SEPTEMBER 16, 2014

OVERVIEW

The National Association of Manufacturers (NAM) welcomes the opportunity to submit this statement for the record for the Senate Finance Committee Hearing, "Retirement Savings 2.0: Updating Savings Policy for the Modern Economy" held on September 16, 2014.

The NAM is the largest manufacturing association in the United States, representing small and large manufacturers in every industrial sector and in all 50 states. Manufacturing employs more than 12 million men and women, contributes \$2.08 trillion to the U.S. economy annually and accounts for two-thirds of private-sector research and development. The manufacturing sector represents 12.5 percent of our nation's gross domestic product (GDP).

NAM members know first-hand that our current tax system is fundamentally flawed and discourages economic growth and U.S. competitiveness. As a result of manufacturing's critical importance to our nation's economy, any effort to rewrite the federal tax code should result in a balanced, fiscally responsible plan that allows manufacturers in the United States to prosper, grow and create jobs and also enhances their global competitiveness.

The following comments, which focus specifically on the employee benefits provisions in the tax code, reflect NAM Board-approved policy on tax reform and do not reflect the entirety of our views of what is required in a comprehensive tax reform plan.

Employee Benefits

Manufacturers have long provided generous benefits to their employees, reflecting their commitment to their workforce—an essential factor in the success of manufacturing in the United States. To that end, it is important to manufacturers that an improved, pro-job, pro-growth, pro-competitive tax code maintains some key priorities specifically regarding the tax treatment of employee benefits.

In particular, NAM members believe that a tax reform plan should continue to recognize that private-sector employee benefit plans efficiently offer medical, health and retirement benefits to workers. The tax treatment of employee medical, health and retirement benefit plans should permit employers to exercise reasonable discretion in

determining the types, coverage, conditions of eligibility, contributions and investments necessary to attract and retain qualified workers in a globally competitive market.

In addition, tax policy should encourage, rather than impede, the adequate funding of private, voluntary retirement plans. Accordingly, income and gains of the assets of such plans should be permitted to accumulate free of all taxes. The federal government can best help individuals attain economic security by fostering economic conditions and incentives that encourage individuals to seek retirement security through personal savings and investment.

A strong Social Security system is also critical to workers' long-term retirement security. Consequently, manufacturers believe that the Social Security system should be adequately funded to preserve the current safety net for American workers. However, the NAM believes that the system's projected shortfalls should not be paid for by increased employer costs. During the current debate, we appreciate the bipartisan support for reforming Social Security by using a more realistic basis for calculating cost-of-living increases. Absent Social Security reform, beneficiaries could face as much as a 25 percent cut to their benefits beginning in 2033. We strongly support Congressional efforts to reach a bipartisan solution to ensure the long-term solvency of this program.

Since the Committee is examining retirement savings policy, we want to take this opportunity to more fully detail the manufacturing perspective.

Retirement Savings

Historically, manufacturers have provided generous benefits for their employees, reflecting their commitment to their workforce—an essential factor in the success of manufacturing in the United States. To that end, it is important to manufacturers that an improved, pro-job, pro-growth, pro-competitive tax code maintains some key priorities in the tax treatment of retirement security.

The savings rate in America is low, with only 18 percent of workers very confident about having enough money for a comfortable retirement, according to the Employee Benefit Research Institute 2014 Retirement Confidence Survey.¹ However, the same survey finds that employer-sponsored retirement plans help to encourage employees to save for retirement, with 70 percent of employees reporting that they are offered a retirement plan with their current employer and 77 percent reporting that they contribute money to the employer-provided plan.² Given these statistics, Congress should not take away incentives for retirement savings or discourage employers from continuing to sponsor plans.

The NAM believes tax policy should encourage, rather than impede, the adequate funding of private voluntary retirement plans. Accordingly, income and gains of the assets of such plans should be permitted to accumulate free of all taxes. The federal government can best help individuals attain economic security by fostering economic conditions and incentives that encourage individuals to seek retirement security through personal savings and investment.

¹ Employee Benefits Research Institute, Ruth Helman, Nevin Adams, Craig Copeland, and Jack VanDerhei, "The 2014 Retirement Confidence Survey: Confidence Rebounds—for Those with Retirement Plans," EBRI Issue Brief, no. 397 (March 2014).

² *Ibid.*, 18

Manufacturers lead all other industries in offering retirement benefits and promoting retirement savings: 81 percent of employees in manufacturing jobs have access to retirement benefits, compared to 64 percent of employees across all industries.³ Of workers with access to plans, 83 percent of manufacturing employees participate in their employer's retirement plans.

The NAM also believes it is important to allow employers flexibility in designing their employees' retirement benefits. Consequently, the NAM has concerns with proposals to limit plan contributions, or to require that contributions over a certain threshold be diverted into an after-tax Roth account. These types of proposals lack flexibility and may discourage employers from continuing plan sponsorship. Many manufacturers do not currently have a Roth option and would be forced to start a new system, creating new recordkeeping and other administrative burdens and the need educate employees about the new plan design. This added complexity, among other things, could be the tipping point to make an employer decide not to begin sponsoring a plan or to terminate its existing plan.

It is also important to note that taxes on the contributions made to pre-tax defined contribution plans are simply deferred, not excluded. When an employee retires, the distributions from the retirement plan are taxed and the revenue flows to the U.S. Treasury. Limiting contributions to pre-tax retirement plans may appear to raise revenue now in the narrow 10-year budget window, but would simply shift the tax revenue received upon retirement to the near-term, harming the retirement security of workers.

PBGC Premiums

Many manufacturers—particularly long-established businesses—offer or have offered their employees “traditional pension” or defined benefit (DB) plans. For a variety of reasons, including complex regulatory compliance requirements, legal liability, the advent of fierce global competition, longer life expectancies and changing career paths, companies have been exiting the DB plan system. Despite this trend, employers continue to fund these plans long after they are closed. In doing so, employers provide important benefits to long-serving employees who continue to work for the company or have deferred settlement with the plan until their retirement. As Congress works to reform our tax system, we urge you to address several issues that will help foster a better DB system and enable manufacturers to continue to provide these important benefits to employees.

The growing cost of Pension Benefit Guaranty Corporation (PBGC) premiums imposes a significant financial burden on sponsors of DB plans. While the PBGC was established to serve as the backstop to DB plans, in reality the overwhelming majority of companies will pay out all the dollars they owe their participants without any help from PBGC. Nonetheless, plan sponsors are forced to pay hundreds of thousands—and in some cases millions—of dollars per year to the PBGC. Manufacturers have historically been a leading provider of DB pension plans, and as a result pay the most in PBGC premiums out of any industry, funds that could otherwise be used for productive business investments. Every additional dollar that employers must pay to the PBGC is

³ U.S. Department of Labor Bureau of Labor Statistics, “National Compensation Survey: Employee Benefits in the United States, Table 1,” (March 2013).

one less dollar that can be used to fund participant benefits, expand their businesses, create jobs, and grow the economy.

Discussions in Congress about further increasing PBGC premiums, which are already indexed to inflation, are occurring more and more frequently – particularly, outside of the context of retirement policy. Congress has already enacted two PBGC premium increases in the last two years that total nearly \$17 billion over ten years. Additional PBGC premium increases, when added to the multi-billion dollar increases enacted in 2006, 2012, and 2013, could divert additional resources from job creation and business investment. According to a recent study⁴, adding the Administration's budget proposal to the recent premium hikes equates to a potential loss of 42,000 jobs per year on average, peaking at 67,000 jobs in 2017, which would equate to a \$51.4 billion hit to the U.S. economy over 11 years. Companies must budget and plan in advance for cost increases, and in many cases, a PBGC tax hike means less money for other investments. Congress could save an average of 24,500 jobs per year by rejecting additional premium increases.

Manufacturers oppose any additional increase in PBGC premiums as part of tax reform or any other legislative vehicle. We also strongly oppose any effort – such as the proposal found in the Administration's budget proposal – to grant the PBGC the authority to set its own premiums. We believe such an arrangement would result in premiums being set based on a much narrower set of priorities than under current practice and would give too much authority to the PBGC while simultaneously relinquishing Congress's authority to set premiums.

ERISA Section 4062(e)

Finally, the burden created by Section 4062(e) of the Employee Retirement Income Security Act (ERISA) causes continual concern for employers with DB plans. While designed to protect the retirement assets of workers when a company closes its doors, employers can incur huge liabilities to PBGC for simple and routine business reorganizations. Manufacturers believe this provision and PBGC's interpretation and enforcement of the provision injects unnecessary uncertainty and possibly significant additional costs into legitimate business planning. The NAM supports legislation (S. 2511) introduced by Senators Tom Harkin (D-IA) and Lamar Alexander (R-TN) to modify the definition of "cessation of operations" under ERISA so manufacturers will know exactly what changes to business operations trigger liability. The NAM will continue to urge Congress to enact this important pension law clarification.

Nondiscrimination Rules for Qualified Plans

Many manufacturers that sponsor DB plans would like to be able to transition from a DB plan to a defined contribution (DC) plan structure to reflect the changing nature of the workplace and employees' needs. To allow companies to provide a meaningful transition period, the NAM supports a change to the nondiscrimination rules applicable to qualified retirement plans.

In particular, manufacturers support a solution that would allow companies, in cases where a defined benefit plan is frozen, to grandfather a nondiscriminatory group of

⁴ Inforum, *Increasing Pension Premiums: the Impact on Jobs and Economic Growth* (2014)

employees so they may continue to accrue benefits and be treated as a nondiscriminatory group on a permanent basis, unless plan amendments modify the group or the applicable benefit formula. This solution would prevent frozen plans from violating the rules prohibiting discrimination in favor of highly compensated employees.

Unfortunately, current nondiscrimination rules effectively do not allow for any meaningful grandfathering period. As a result, discrimination tests can potentially have an adverse effect on many manufacturers' older employees who have many years of dedicated service. For example, the simplest and surest way to ensure compliance with the nondiscrimination rules is to completely freeze the plan, often called a "hard freeze." Another method to comply with the nondiscrimination rules is to remove highly compensated employees from the plans, starting with employees who barely clear the highly compensated employee threshold. Clearly both of these solutions negatively impact employees' long-term retirement security.

In contrast, many manufacturers have designed their transition from a DB plan to a DC plan to allow older, long-service employees close to retirement to maintain their DB plan. Unfortunately, to pass the nondiscrimination tests, some companies may be forced to change the retirement benefit structure (i.e., from DB to DC) for employees closest to retirement who have the least amount of time to make up the difference—the very outcome employers sought to avoid by implementing the transition period.

Recently, the IRS provided temporary nondiscrimination relief for closed DB plans in IRS Notice 2014-5, which will allow manufacturers to satisfy the nondiscrimination requirements for the 2014 and 2015 plan years if the closing of the plan to new entrants ("soft freeze") was adopted before December 13, 2013, and the plan satisfies several other requirements. This temporary relief provides many manufacturers with additional time to continue offering pension benefits to those workers grandfathered in the plan. Without the temporary fix, manufacturers may have been forced to completely freeze the plan.

While the temporary relief is helpful in the near-term, manufacturers still need a permanent solution to allow for an adequate transition from DB to DC plans in 2016 and beyond. The NAM urges Congress and the IRS to consider a permanent solution that would allow a plan to meet the nondiscrimination requirements permanently if the plan satisfied the nondiscrimination test at the time it was closed, or at a later date. Specifically, if a group of employees is grandfathered under a DB plan and that plan satisfies the nondiscrimination test when it was closed to new hires, then the DB plan would be deemed to satisfy the nondiscrimination requirement thereafter (unless the group or the benefit formula applicable to the group is enhanced). This solution would address manufacturers' concerns that over time, their soft frozen plans may inadvertently violate the nondiscrimination rules, eliminating the likely scenario that the company would need to completely freeze the plan to avoid tripping the test.

In sum, the NAM supports changes to the nondiscrimination rules, providing that if the nondiscrimination tests are satisfied as of the date of the plan freeze, then they are deemed satisfied thereafter unless the employer amends the plan to make a material change to the grandfathered group or to the benefit formula.

Phased Retirement

Employers of all sizes are facing the issue of how to retain their critical talent as large numbers of employees near retirement age. According to the Pew Research Center, approximately 10,000 Americans will turn 65 every day until 2030. This fact is causing many manufacturers to lose the services of these highly skilled, experienced workers because the benefits laws create limited options: either continue to work or fully retire. In already challenging times, companies face a significant loss in institutional knowledge, leadership and talent due to retirements. They do not have the ability to gradually phase these skilled workers into retirement, which would enable the transfer of valuable knowledge to the next generation of workers. This loss will continue unless the law is changed to allow employers to offer an alternative to employees: voluntary phased retirement.

Phased retirement allows an employee approaching retirement age to work a reduced schedule and/or take on different responsibilities for a set period, eventually transitioning from working to retiring. Phased retirement may include a pre-retirement, gradual reduction of work and/or post-retirement, part-time work for pensioners who wish to remain employed. The benefits of encouraging phased retirement could be significant. Employers would not experience major workforce disruptions or the loss of critical talent and institutional knowledge. Employees who want the additional financial security of employment can continue to work and earn wages and benefits while transitioning gradually into retirement. Although financial resources influence retirement decisions, employees who have a high level of job satisfaction and feel valued by their employers do not necessarily want to retire at the required age. Importantly, allowing employers the flexibility to design bona fide phased retirement programs can help not only address the issue of retaining critical, highly skilled talent, it can also broaden the tax base and reduce the pressure on federal retirement programs such as Social Security and Medicare.

Unfortunately, employers face several barriers to implementing a phased retirement program. Both the tax code and ERISA impose requirements that limit flexibility in retirement plans sponsored by private employers. For example, current law prohibits private sponsors of DB plans from making in-service distributions for employees who have not yet reached normal retirement age or age 62⁵. This age restriction limits the employers' ability to offer phased retirement to workers eligible for early retirement under their pension plans. Importantly, employers will not offer these programs if they are considered a "protected benefit" subject to the tax code's anti-cutback rules. Also, current regulations would make it difficult to pass nondiscrimination testing based on the inclusion of beneficiaries who participate in a phased retirement program.

Of note, the President recently signed into law a phased retirement option for eligible Federal employees. The rationale is to encourage the most experienced Federal employees to extend their contributions to the nation and help agencies improve continuity of operations by bolstering mentoring and knowledge-retention programs. The same rationale applies to private employers, who also need the flexibility to offer voluntary phased retirement programs to their critical employees in a nondiscriminatory manner

⁵ It is unclear whether in-service distributions from a DB plan are permitted on the attainment of the plan's early retirement age.

based on workforce needs. By making small changes to the law, phased retirement programs can offer employers the flexibility to design a retirement strategy that makes sense and employees the ability to change what it means to retire.

Conclusion

Manufacturers have a long history of providing generous benefits for their employers and the NAM wants to ensure that this tradition, which serves employers and employees alike, continues. To that end, it is important to manufacturers that an improved, pro-job, pro-growth, pro-competitive tax code maintains the key priorities outlined above regarding the treatment of employee benefits.

Manufacturers very much appreciate the efforts of the members of the Senate Finance Committee for their diligent work to reform the U.S. tax system, and for their review of the current retirement savings system. The NAM thanks you for the opportunity to share our thoughts and concerns with you, and we look forward to further discussing these issues and working with the Committee to achieve a pro-growth, pro-competitiveness and pro-manufacturing tax system.



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September 16, 2014

Committee on Finance
United States Senate
Washington, DC 20510

Dear Senator:

The National Education Association respectfully submits these comments for the record in conjunction with today's hearing, "Updating Savings Policy for the Modern Economy."

Traditionally, sources of retirement income for Americans have been compared to a three-legged stool supported by pensions, Social Security, and savings. For most Americans, however, the metaphor no longer reflects the reality:

- More than 30 percent have no retirement savings or pensions at all—including 19 percent of those ages 55 to 64. (Source: *Report on the Economic Well-Being of U.S. Households in 2013*, Board of Governors of the Federal Reserve, July 2014)
- The average working household has virtually no retirement savings—the median retirement account balance is just \$3,000 for all working-age households and \$12,000 for near-retirement households. (Source: *The Retirement Savings Crisis: Is It Worse Than We Think?* National Institute on Retirement Security, July 2013)

NEA is a leading advocate for financially stable, employment-based, defined benefit pension plans in both the public and private sectors of the economy. Our knowledge of such plans has been gained firsthand and through the experience of our affiliates, nearly all of whom maintain defined benefit pension plans—on both a single employer and multiemployer basis—for their own employees. Such plans are advantageous for both employees and employers.

For employees, the advantages include:

- **Knowing in advance what the benefit will be.** The amount of the benefit is usually based on factors such as age, earnings, and years of service.
- **Defined, guaranteed pension.** A retired participant receives a pension annuity, such as a monthly benefit, for life, as does the participant's surviving spouse, unless both the participant and spouse elect otherwise.
- **Comprehensive benefits.** Defined benefit plans can provide additional valuable benefits to participants, such as early retirement benefits, disability benefits, death benefits, benefits for past service, increased benefits, or cost-of-living adjustments.
- **Benefits are not subject to the fluctuations of the stock or bond markets.** The employer bears the investment risk and, normally, professional money managers make the investments.
- **Plan participants can earn service credit for earlier years of service,** even if they were not covered by a retirement plan earlier in their careers.

For employers, the advantages include:

- **Helping to ensure a high-performance workforce.** By providing a predictable, guaranteed benefit at retirement that is valued by employees, a defined benefit plan can promote employee loyalty and help retain valuable staff.
- **Flexibility.** While the employer bears the investment risks for the plan, favorable interest rates and economic conditions can reduce or eliminate an employer's contribution, or make it possible to increase benefits at reduced or nominal cost.
- **Can be designed to accomplish specific goals.** For example, a plan can offer enhanced early retirement benefits.
- **Less expensive.** Generally, it is less expensive to provide the same level of benefits via a defined benefit plan than a defined contribution plan due to better investment results, lower investment fees, longer time horizons, and more professional management.

For most Americans—especially racial and ethnic minorities, and those on the lower rungs of the economic ladder—Social Security is the foundation of retirement security. Among those 65 or older, Social Security provides:

- 85 percent of the income of those in the bottom quarter of the income distribution or about \$6,000 per year. (Source: *When Thinking about Retirement, Beware the Averages*, Wall Street Journal, Jan. 23, 2014)
- 90 percent or more of income for 35 percent of elderly white beneficiaries, 42 percent of Asian Americans, 49 percent of blacks, and 55 percent of Hispanics. (Source: *Policy Basics: Top Ten Facts about Social Security*, Center on Budget and Policy Priorities, Nov. 6, 2012)

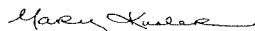
While almost all our members have public sector defined benefit pension plans, some educators face a different retirement security problem: they are being unfairly deprived of Social Security benefits they have earned. The Government Pension Offset (GPO) reduces public employees' Social Security spousal or survivor benefits by two-thirds of their public pension. It affects people who work as federal, state, or local government employees, including educators, police officers, and firefighters, if the job is not covered by Social Security. Nationwide, more than one-third of teachers and education employees, and more than one-fifth of other public employees, are not covered by Social Security, and are, therefore, subject to the GPO. An estimated 9 out of 10 public employees affected by the GPO lose their entire spousal benefit, even though their deceased spouse paid Social Security taxes for many years.

The Windfall Elimination Provision (WEP) reduces the earned Social Security benefits of an individual who also receives a public pension from a job not covered by Social Security. It affects people who worked in jobs not covered by Social Security and in jobs in which they earned Social Security benefits—such as educators who do not earn Social Security in the public schools, but who work part-time or during the summer in jobs covered by Social Security. The WEP penalizes individuals who move into teaching from private sector employment, or who seek to supplement their often insufficient public wages by working part-time or in the summer months in jobs covered by Social Security.

In summary, we urge you to provide the funding flexibility necessary for defined benefit pension plans to survive; maintain current Social Security benefit levels while eliminating GPO and WEP, which unfairly deprive hard-working Americans of benefits they have earned; and provide incentives to encourage personal savings, especially for those who are not covered by employment-based pension plans.

We thank you for the opportunity to submit these comments.

Sincerely,



Mary Kusler
Director of Government Relations



Supporting Those Who Serve

Statement of Philip C. Stittleburg
 Chief, La Farge (WI) Fire Department
 Chairman, National Volunteer Fire Council (NVFC)
 7852 Walker Drive, Suite 375
 Greentbelt, MD 20770

Submitted to the U.S. Senate Committee on Finance
 For the hearing record for: "Retirement Savings 2.0: Updating Savings Policy for the Modern Economy"
 September 16, 2014

My name is Philip C. Stittleburg and I have been the Chief of the La Farge (WI) Fire Department since 1977 and a member of the Board of the National Volunteer Fire Council (NVFC) since 1979. Since 2001 I have served as the Chairman of the NVFC Board. A short version of my bio is included at the end of my testimony.

Thank you for the opportunity to provide information regarding the impact that federal taxation has on Length of Service Award Programs (LOSAPs), which many communities provide to their volunteer emergency responders as a retention incentive. LOSAPs are retirement accounts designed for volunteer emergency responders. Approximately 20 percent of the nation's 783,300 volunteer firefighters are enrolled in some type of LOSAP. The basic idea behind LOSAP is that the department and/or the local or state government contribute money into an account for every year that someone volunteers and once the volunteer reaches retirement age they draw a benefit.

Prior to 1996, LOSAP was nowhere to be found in the federal tax code. It was generally treated like a normal retirement plan but there was a lot of ambiguity, which made LOSAP difficult to administer and led to other problems. In 1996, Congress addressed this by formally adding LOSAP in Internal Revenue Code Section 457(e)(11)(B). This fixed a number of problems but, we realized years later, unintentionally created several new issues. The NVFC ultimately formed a LOSAP Committee to study these issues and develop solutions.

The first issue identified by the Committee was that for certain types of LOSAP, contributions made into a plan cannot be guaranteed to the volunteer that they are intended for. The tax code specifies that employer contributions into a retirement account cannot be larger than 100 percent of compensation in the form of salary, wages or other benefits. This might make sense for an employee who receives a regular wage or salary in addition to pension contributions, but for volunteers who receive no compensation outside of the LOSAP it is problematic.

To comply with the '100 percent rule' many LOSAPs are either not funded or the funds are set aside but not guaranteed to the individual volunteers. As a result, if the entity responsible for the LOSAP declares bankruptcy, volunteers risk losing their benefits. Additionally, if the volunteer is unable to maintain their active status all the way through until they reach retirement age they may be forced to draw their LOSAP prematurely and be subject to early withdrawal penalties.

The second issue is that the 1996 law established a \$3,000 annual ceiling on contributions into an individual's LOSAP. The cap has never been adjusted for inflation and as nominal contribution levels

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have increased this has led to difficulty for a number of departments. Plans that provide higher contribution levels for each year of service have been particularly affected by this as an increasing number of volunteers serve their departments later in life.

Finally, many volunteer fire and EMS agencies are private, non-profit organizations that are typically funded by and authorized to provide services based on the terms of a written agreement with a local unit of government. These types of arrangements typically came about in places where the emergency services agency was established prior to the local government unit. Because these agencies are not technically governmental their LOSAPs are treated as private plans for the purposes of taxation. This means that they are subject to far much more stringent reporting requirements than governmental plans, despite the fact that LOSAPs are modest retirement accounts and the agencies that provide them are quasi-governmental.

Because the federal tax treatment of LOSAP is unnecessarily confusing and restrictive, some states have been hesitant to pass laws authorizing local departments and/or governments to establish plans. Without state authorization, plans are difficult to establish and local governments are frequently prevented from contributing funds. Even in states that do authorize LOSAP, application of the three problematic rules referenced above can make administering plans unnecessarily costly and confusing.

To fix these problems, the NVFC supports passage of the Volunteer Emergency Services Recruitment and Retention Act, S. 506, either as a standalone bill or as part of the EXPIRE Act. This would provide greater security for the approximately 250,000 volunteer fire and EMS personnel who currently participate in LOSAP. It would also make it easier for local departments to establish and maintain LOSAP plans.

Why LOSAP is Important

Volunteer fire and EMS agencies are finding it increasingly difficult to recruit and retain the next generation of volunteer emergency responders. To put this into context for you I'd like to describe the challenges facing my own department before broadening out to discuss national trends and data. The La Farge Fire Department is an all-volunteer fire department that has a first-due response area covering approximately 135 square miles and containing about 2,750 residents and 85 commercial buildings. Approximately 1/3 of our personnel have been members of the FD for 20 or more years, 1/3 for 10-20 years and the remaining 1/3 for less than 10 years.

My department's long-rang planning committee has determined that due to the age of our firefighters that we will need to replace approximately 1/3 of our personnel in the next few years AND retain almost all of the rest of the department's personnel that are not approaching retirement age simply to maintain our existing level of service provision. We have found that long term commitments to the department are becoming increasingly difficult to cultivate with increasing demands on volunteers' family and personal time. Additionally, being located in a rural community, many of our current and prospective volunteers are commuting out of the area for work, making them unavailable for daytime, weekday responses and leaving less time on nights and weekends for training. Last year, my department established a length of service award program (LOSAP) with a goal of stabilizing our staffing levels.

Our circumstances at La Farge FD are fairly typical of volunteer fire departments around the country, especially those protecting our nation's smallest communities. The population of rural areas where volunteer emergency responders are most common has been declining and aging, as younger people

move to more densely-populated communities to find work. The demographic trends affecting rural America generally track with demographic trends in the volunteer emergency services.

Between 1983 and 2012, the number of volunteer firefighters in the United States declined from 884,600 to 783,300, an 11.5 percent reduction. A significant portion of this decline can be attributed to a reduction in the number of younger volunteer firefighters serving in communities with populations of 2,500 or fewer residents. Between 1987 and 2012, the number of firefighters under the age of 40 serving communities of 2,500 or fewer residents dropped from 282,821 to 187,089, a decline of 33.8 percent.

As the number of younger volunteer firefighters has fallen off, more older volunteers have delayed retirement. Between 1987 and 2012, the number of over-40 firefighters serving communities with populations of 2,500 or less rose from 164,681 to 204,311. Unfortunately, this trend is not sustainable. Today, more than 30 percent of the firefighters in our nation's smallest communities are over the age of 50 while the number of firefighters in the 30-39 and 40-49 age cohort are the lowest they have ever been (the under 30 cohort in 2012 was the fifth-lowest on record). Unless recruitment and retention rates increase dramatically there simply are not enough younger volunteer firefighters in the pipeline to replace all off the older volunteers who will be retiring over the next decade or so.

Recruitment and Retention

Fire departments have a number of tools at their disposal to deal with a lack of volunteers. Many historically volunteer fire departments have hired career personnel to work beside the volunteers or to cover day-time, week-day shifts when most volunteers are at work. Departments also pool resources with neighboring agencies through mutual aid or consolidation to ensure that an adequate number of responders are available at all times.

Ultimately, recruitment and retention of volunteers is the key to ensuring the long-term viability of emergency services provision in rural areas. Volunteers comprise approximately 70 percent of the nation's firefighters and all- and mostly-volunteer departments make up more than 85 percent of the fire departments in this country. The value of the services donated by volunteer firefighters annually is estimated to be \$140 billion, primarily benefitting communities with small tax bases that cannot afford to hire full-time career staff. In short, the volunteer emergency services are irreplaceable.

In thousands of communities, volunteer fire chiefs are grappling with how to maintain staffing levels in the face of significant demographic challenges. Recruiting, training and equipping volunteers is a costly and time-consuming process, which makes retention tools like LOSAP critical. Many departments, including my own, have found that offering a LOSAP for long-serving volunteers can be the difference between someone leaving the department after a few years or sticking around for a few decades. Passage of this the Volunteer Emergency Services Recruitment and Retention Act would simplify the treatment of LOSAP under the federal tax code, making it easier for local communities and states to offer a retirement benefit to help recruit and retain volunteers.

Chief Philip C. Stittsburg, B.A., J.D., FFireE, CFO, entered the volunteer fire service in 1972 after working as a paid member of a combination fire department. He has served as chief of the La Farge (Wisconsin, USA) Fire Department since 1977. Chief Stittsburg is currently serving his sixth two-year term as chairman of the board of directors of the National Volunteer Fire Council (NVFC) and his first one-year term as chairman of the board of directors of the National Fire Protection Association (NFPA). He is also

a member of the board of directors of the National Fallen Firefighters Foundation (NFFF). In 1998, Chief Stittleburg was named Fire Chief magazine's volunteer fire chief of the year.

Chief Stittleburg has authored over 100 published articles on various fire service topics and has been a regular contributor to Fire Chief magazine's legal column for over twenty years. He has written portions of several fire service books, writes and teaches undergraduate university fire service courses, and frequently speaks to fire service audiences throughout the United States and internationally.



**STATEMENT FOR THE RECORD OF
THE PLAN SPONSOR COUNCIL OF AMERICA**

As submitted to the

**UNITED STATES SENATE
COMMITTEE ON FINANCE**

On

Retirement Savings 2.0: Updating Savings Policy for the Modern Economy

Tuesday, September 16, 2014

On behalf of the Plan Sponsor Council of America (“PSCA”), we would like to thank Chairman Wyden and Ranking Member Hatch for their continued commitment to improving retirement savings for American workers. PSCA is a national, non-profit association that advocates on behalf of 1,200 companies and their six million employees for increased retirement security through profit sharing, 401(k) and related savings and incentive programs. PSCA was established in 1947 and its member companies include both large and small employers ranging in size from Fortune 100 firms to small, entrepreneurial businesses. Our members include both plan sponsors *and* plan service providers working together to improve the defined contribution landscape.

We believe that Americans need to save more for retirement, and we support policies with this goal in mind. However, improvements should not come at the expense of already successful policies. Rather, we urge the Committee to remain mindful of the many ways in which the current employer-based retirement system is working for millions of workers and is enhancing their retirement security, along with individual retirement plans, individual savings and Social Security.

The tax incentives that Congress has created are an important impetus for individuals to save for retirement and for employers to offer plans under a voluntary system. It is also important to understand that income derived from retirement plan contributions is tax-deferred income and not excluded from tax. Distributions are taxed as ordinary income.

The tax treatment of employer-sponsored plans encourages business owners to provide retirement programs for their employees and provides workers with an effective way to save through payroll deductions. Under current law, if business owners sponsor retirement plans, they also cover and provide benefits to all eligible employees, including lower-income and middle-income employees.

More than 70 percent of American workers making between \$30,000 and \$50,000 a year contribute to their own retirement when covered by retirement plans at work.¹ Many American workers also enjoy a retirement savings contribution from their employers. According to a PSCA survey in 2013, 95.3 percent of 401(k) plans included an employer matching or non-elective employer contribution. Under the current system, employers have contributed almost \$3.7 trillion to public and private retirement plans from 2001 through 2010.²

Without the opportunity to save through payroll deduction supported by the current system of tax incentives designed to spur retirement savings, millions of Americans would not save for retirement or would have inadequate retirement. Policymakers should consider the potential negative impact that reduced savings could have on business, capital markets, the government and retirees. The private retirement system is working, and we urge the Committee to support that system.

PSCA looks forward to working with the Committee in pursuit of policies that will further enhance Americans' retirement security.

Respectfully submitted,

Plan Sponsor Council of America

¹ Employee Benefit Research Institute (EBRI) estimate using 2008 Panel of Survey of Income and Program Participation (SIPP) data and 2010 EBRI data of workers not covered by an employer plan but saving through an IRA.

² EBRI tabulations of data from the Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts of the United States and the Department of Labor, Bureau of Labor Statistics, Consumer Price Index.



United States Senate Committee on Finance

*Retirement Savings 2.0: Updating Savings Policy for the Modern
Economy Hearing*

Tuesday, September 16, 2014

215 Dirksen Senate Office Building

Statement for the Record

Greg Burrows

Senior Vice President, Retirement and Investor Services
The Principal Financial Group®

United States Senate Committee on Finance:

Retirement Savings 2.0: Updating Savings Policy for the Modern Economy Hearing

As the Senate Finance Committee considers additional steps to help Americans save for retirement within the context of its work on comprehensive tax reform, the Principal Financial Group® is pleased to offer insight based on our work with thousands of small- and medium-sized business retirement plan clients and millions of their employees.

As a leading provider of retirement plans and a global investment management leader, the Principal Financial Group provides comments based on more than 70 years in the retirement industry and our experience with small- to medium-sized employers and their employees. We currently provide retirement services to more than 43,000 retirement plans and 4.2 million employee participants, including more than 38,000 retirement plans of small businesses¹ and their 1.6 million participants.

Our Defined Contribution System has been successful in helping millions of Americans save for retirement. On their own, DC plan assets now represent more than one-quarter of all U.S. retirement assets. When combined with estimated Individual Retirement Account assets, much of which originated from DC plans, these accounts represent more than half of all U.S. retirement assets.²

And while DC plans were impacted by the recession just as everything else in our economy, they have shown incredible resilience with participation rates, deferral rates and company contributions now being equal to or higher than they were before the recession. Nearly half of all plans have now adopted an automatic enrollment feature and more plan sponsors are defaulting participants at deferral rates higher than 3 percent. Over half of these plans automatically increase default deferral percentages in subsequent years.³

But more can be done. As the Committee has appropriately highlighted, we must find ways to enhance our current voluntary retirement system to provide even greater financial security to American workers in retirement. More Americans need access to worksite retirement plans. Those who do have access to plans need to save more. More near-retirees and retirees should consider securing guaranteed income from their account balances. In order to accomplish these goals, necessary enhancements must focus on expanding workplace retirement plan coverage to more Americans, increasing both participation and savings levels in these plans and encouraging plan sponsors to offer and participants to secure guaranteed income for their retirement.

Just as critical, current tax incentives for retirement programs should be preserved. These incentives are successfully encouraging Americans to save for retirement and employers to establish plans. Reducing or removing incentives would very likely decrease savings and reduce the number of employer-sponsored plans, which would have a detrimental impact on overall retirement security for Americans and the economy as a whole.

¹ Retirement plans of small business defined as those with less than 500 participants.

² Defined Contribution Plan Participants' Activities, First Half 2013 (November 2013) – ICI Research Report.

³ PSCA's 56th Annual Survey of Profit Sharing and 401(k) Plans.

Current Retirement Tax Incentives Should Be Preserved

The Principal® knows from experience that retirement tax deferrals have been and continue to be a key incentive in helping millions of Americans save for retirement and are critical to improving retirement outcomes for Americans. Being able to show participants that a pre-tax deferral has a much less dramatic impact on their take-home pay than they expect is a critical—and often convincing—key message during the enrollment process and while encouraging annual increases.

Recent surveys validate that American workers strongly support current incentives and deeply oppose cuts:

- Forty-five percent of workers say they would stop or reduce contributions to worksite retirement plans if they could no longer do so on a pre-tax basis.⁴
- Lower income workers (\$35,000 or less) would be much more likely to stop contributing if the tax incentive were removed. Twenty-four percent with incomes less than \$35,000 said they would stop contributing compared to 11 percent for incomes of \$35,000 to \$74,000 and 17 percent of incomes over \$75,000.⁴
- Among households with defined contribution accounts and IRAs, eighty-three percent oppose reducing the amount that individuals can contribute. Even modest-income households making less than \$30,000 opposed reductions (73 percent).⁵

Retirement plan tax deferrals are not tax forgiveness and the budgetary scoring process should be changed to account for future tax revenue. These tax incentives have been mischaracterized as expenditures when in fact they are and will continue to be a revenue source for the government. The federal government eventually collects significant tax revenue on distributions from tax-deferred retirement savings. When workers withdraw money from their retirement accounts, they generally pay ordinary income taxes not only on the original savings but also on the potential accumulated, compounded earnings – earnings they wouldn't have if workers hadn't been incentivized to save in the first place. The return on this investment to the government is significant.

Our analysis of a typical, middle-income worker shows that over the course of a 40-year career, for every \$1 of taxes deferred, the federal government collects at least \$4 in tax revenue when the contributions and earnings are withdrawn⁶ (see Appendix I).

With \$12.6 trillion⁷ currently saved in worksite retirement defined contribution plans and IRAs, the government will be collecting significant tax revenue for many years to come. Congress should consider changing the laws governing the budgetary scoring process to use more dynamic metrics when it comes to retirement tax deferrals to recognize this future stream of revenue.

⁴ Employee Benefit Research Institute 2013 Retirement Confidence Survey.

⁵ America's Commitment to Retirement Security: Investor Attitudes and Actions, ICI 2013.

⁶ Analysis by the Principal Financial Group. See Appendix I for assumptions used.

⁷ Investment Company Institute news release, "Retirement Assets Total \$23.0 Trillion in First Quarter 2014," June 25, 2014.

Cutting tax incentives would harm middle to lower income workers and pre-retirees. Non-discrimination rules and safe harbors carefully balance the benefits in 401(k) plans between higher- and lower-paid workers, ensuring that benefits are very progressively distributed. As a result, the tax incentives for retirement savings flow overwhelmingly (89 percent) to taxpayers whose income is under \$200,000⁸.

Among the more than 4 million workers who participate in plans serviced by The Principal, 43 percent of those who saved the maximum tax deferred amount make less than \$110,000 and two-thirds of them are age 50 or older. Reductions in tax incentives would have a negative impact on the very people Congress is trying to protect: **non-highly compensated workers and pre-retirees**.

As for Individual Retirement Accounts (IRAs), the vast majority of contributions to IRAs (95%) come from rollovers from employer-sponsored retirement plans⁹. Concerns regarding \$1 million balances in IRAs should be tempered with the knowledge that this is likely the result of a career worth of saving and investing in an employer-sponsored retirement plan, and that taxes will be paid on these balances at withdrawal.

Reducing retirement incentives means reducing sources of long term capital. Since these trillions of dollars are being invested in our capital markets and support the overall growth of our economy, any changes made to restrict or lessen these tax deferrals for retirement savings could have severe long-term implications. Specifically, in 2012 we estimate that approximately 33.4 percent of the value of the US stock market was attributed to contributions which came from DC plans and IRAs¹⁰. Reducing retirement incentives means reducing sources of long term capital which ultimately means lower GDP growth rates at the very time that we need long term capital to support higher economic growth for all Americans.

Move Beyond Preserving the System to Enhancing the System

Congress can help expand financial security for Americans by building on the current employer-sponsored system. By removing barriers to new retirement plan formation and encouraging plan designs that increase participation and savings, Congress can help more Americans have access to retirement plans and encourage them to save more effectively.

The Principal recommends the following steps:

Simplify rules, plan designs and regulations to make it easier for employers to offer and plan sponsors to operate retirement plans. Survey results from the *Principal Financial Group Retirement Readiness*

⁸ *Estimated Benefits of Tax Expenditure Estimates for Defined Contribution Plan Participants and Retirees with Account Balances*, prepared for The American Society of Pension Professionals and Actuaries (ASPPA), 2011.

⁹ 2013 Cerulli & Associates

¹⁰ Principal analysis shows 2012 U.S. equity holdings in DC plans and IRAs at \$6.24 trillion, representing 33.4% of total 2012 US stock market assets (\$18.688 trillion).

*Survey*¹¹ found nearly half of plan sponsors felt easing reporting requirements (47 percent) and compliance burdens (42 percent) would help with plan operations. More than half of plan sponsors (52 percent) said allowing all employees to defer up to Internal Revenue Service limits would make it easier for employers to operate their plans.

The same study found more than half of employers (53 percent) not offering a retirement plan are unaware of the start-up tax credit given to employers who start a DC/401(k) plan. Yet, more than a third (35 percent) said the credit would be a strong incentive when considering whether to offer a DC/401(k) plan.

To make it easier to establish and operate retirement plans and improve plan design, we recommend new rules to reduce bureaucracy and administrative requirements for small businesses and for plans that adopt safe harbor and automatic enrollment designs. Title II- Private Pension Reform of Senator Hatch's Secure Annuities for Employee (SAFE) Act provides a roadmap to accomplish these goals, including a "Starter" deferral-only safe harbor plan, an enhanced employer start-up credit and many simplification measures.

Promote adequate savings levels and encourage use of plan design features that increase participation and savings. Congress can help encourage redesigned automatic enrollment features that promote savings. Plan sponsors should be incented to set automatic enrollment at deferral rates higher than 3 percent and to employ automatic annual deferral increases and employer matches structured to incent higher deferrals.

Automatic contribution arrangement safe harbors should be updated to incorporate single-tier match formulas, the most commonly used matching design, as long as the matching rate meets specific requirements.

For example, the safe harbor could require the match on deferrals of at least 6% of pay (or more) and a minimum match rate of 50%, for a minimum required employer contribution of 3% making the minimum total contribution of 9% of pay for the participant. With automatic deferral escalation, participants would soon be in the 10%+ total savings range.

The 10 percent cap on default deferral and automatic annual deferral increases currently in place in the safe harbor should also be removed.

Address the challenge of retirement income. Many individuals simply do not have a realistic understanding of how much money they need in retirement or how much they can spend before they run out of income from their savings. And while many savers are attracted to the idea of a guaranteed income stream in retirement, few actually use their accumulated DC balances to purchase products like income annuities before or at retirement.

¹¹ The 2011 *Principal Financial Group Retirement Readiness Survey* commissioned by Principal Financial Group conducted by Harris Interactive online. Data was gathered May 17-June 17, 2011 from 1,305 employers.

To help change how employees think about saving for their futures, we advocate broader use of retirement income illustrations on benefit statements to drive home how long savings are estimated to last in retirement. We have asked the Department of Labor to address employer concerns about potential liability and encourage the use of these illustrations as a best practice by providing regulatory guidance on how the illustrations are estimates, not guarantees, therefore alleviating fiduciary concerns for plan sponsors.

To encourage broader adoption of guaranteed income products by plan sponsors and use by participants, new safe harbors should be established that alleviate fiduciary concerns related to the selection of an annuity provider and encourage plan sponsors to voluntarily provide education about income annuities in the workplace. Guaranteed income products should also be incorporated into Qualified Default Investment Alternative (QDIA) protections when offered as a diversified asset allocation default.

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About the Principal Financial Group

The Principal Financial Group® (The Principal®)¹² is a global investment management leader offering retirement services, insurance solutions and asset management. The Principal offers businesses, individuals and institutional clients a wide range of financial products and services, including retirement, asset management and insurance through its diverse family of financial services companies. Founded in 1879 and a member of the FORTUNE 500®, the Principal Financial Group has \$517.9 billion in assets under management¹³ and serves some 19.4 million customers worldwide from offices in Asia, Australia, Europe, Latin America and the United States. Principal Financial Group, Inc. is traded on the New York Stock Exchange under the ticker symbol PFG. For more information, visit www.principal.com.

¹² “The Principal Financial Group” and “The Principal” are registered service marks of Principal Financial Services, Inc., a member of the Principal Financial Group.

¹³ As of June 30, 2014.

Appendix I
Worker Savings and Tax Implication Analysis
 From the Principal Financial Group¹⁴

The following estimation is based on an average, middle income worker who would have access to a 401(k) plan with match throughout their entire working career*.

\$74,348	Current amount of taxes the government would have received if the employee had not been allowed to defer 7% annually with 3% employer match (\$265,529 x 28%).
\$328,495	Tax collected on distributions in retirement on a 4.5% draw down rate of the total account balance over a 30 year period (\$2,189,970 x 15% tax rate).
\$4.4 to \$1	For every \$1 of tax deferred, the government will likely get roughly \$4.4 in the future (\$328,495/\$74,348= 4.418).
\$437,994	Tax collected on distributions in retirement on a 4.5% draw down rate of total account balance over a 30 year period (\$2,189,970 x 20% tax rate).
\$5.9 to \$1	For every \$1 of tax deferred, the government will get roughly \$5.9 in the future (\$437,994/\$74,348= 5.891).

Source: Internal analysis

This analysis would be considered a conservative estimate of the tax implications of deferred savings. Factors that would increase the ratio include:

- **A lower marginal tax rate for the worker.** We assumed 28% but could be lower over the workers career on average so would lower the estimates of the current tax amount.
- **A higher effective tax rate in retirement.** We assumed a 15% and 20% tax rate which could be low considering the likelihood of higher rates in the future.
- **A higher draw down rate in retirement.** We assumed a 4.5% draw down rate in retirement which would leave a substantial remaining account balance for heirs. This amount remaining would eventually be taxed as well.

*Details and Assumptions:

- Individual begins saving in 401(k) at age 25 and continues to age 65
- Beginning salary of \$30,000
- 7% deferral rate and 3% employer match
- Annual salary increase of 3.5%
- Pre-retirement marginal tax rate of 28%
- Post-retirement effective tax rate of 15%
- 7% assumed rate of return

This example is for illustrative purposes only. The assumed rate of return used is hypothetical and does not guarantee any future returns or represent the return of any particular investment option.

Insurance products and plan administrative services are provided by Principal Life Insurance Company a member of the Principal Financial Group* (The Principal*), Des Moines, IA 50392.

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¹⁴ Calculation by Principal Life Insurance Company, a member company of the Principal Financial Group.

Statement of
The Savings Coalition of America
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SUBMITTED TO THE
Committee on Finance
U.S. Senate
September 16, 2014 Hearing
Retirement Savings 2.0: Updating Savings Policy for the Modern Economy

September 29, 2014

The Savings Coalition was established in 1991 to support incentives to increase personal savings in the United States. The Coalition's main objective is to enhance savings opportunities for all Americans. There are approximately 45 member organizations of the Savings Coalition representing a wide variety of private interests including banking, securities, financial services, consumer groups, engineering, home-building, realtors, tangible assets, trust companies, health care industry, insurance, education and business groups.

The Coalition commends the Committee for its efforts to make it easier for Americans to save for their retirements. Tens of millions of Americans are saving for retirement and benefitting from the enhancements and simplifications made to retirement savings vehicles. The Coalition believes that more people will save for retirement if the eligibility rules for these vehicles are easier to understand.

In thinking about updating savings policy for the modern economy, the Coalition has three key points:

- **First, there are many components to Americans' retirement resources, which draw from government programs, homeownership, compensation deferred until retirement, and other savings.** Social Security provides a nearly universal base. Complementing Social Security are employer-sponsored retirement plans—defined contribution (DC) plan accounts or defined benefit (DB) plan accumulations, and individual retirement accounts (IRAs). The assets that are specially earmarked for retirement are a key component to Americans' retirement resources and any policy changes should strive to build on this strong system.
- **Second, it is important to recognize that tax deferral is not the same as a tax exclusion or tax deduction; taxes are paid on distributions from retirement accounts and plans.** Reducing contribution limits would hurt workers across all incomes. In addition, Americans support the tax treatment of DC plans and want to preserve the key features of DC plans.

- **Third, the role of individual retirement accounts (IRAs) could be strengthened by simplifying the contribution rules and delaying required minimum distributions (RMDs).** Complex eligibility rules for IRA contributions deter IRA contribution activity; making IRA contributions universally available would encourage saving through IRAs. With growing life expectancies and an age to start RMDs that has not been updated in decades, raising the RMD age would help American workers preserve their IRAs to later in their retirements.

BACKGROUND

The U.S. retirement system is a comprehensive structure where private savings play a fundamental role for ensuring Americans an adequate retirement. The U.S. retirement system taken in its entirety is strong.¹ Rather than a three-legged stool, retirement resources are best thought of as a pyramid.² Social Security forms a strong foundation for the pyramid of retirement resources. Social Security provides retirement income for almost all working Americans, with higher replacement rates for lower-earning households, reflecting the highly progressive Social Security benefit formula. As lifetime earnings increase, Social Security benefits are a smaller and smaller share of workers' earnings. To maintain their standard of living in retirement, workers with higher earnings need to save more of their income to supplement Social Security benefits. Homeownership is another important layer of the pyramid, and some households have other assets. It is important to note that this structure is effective for Americans of all income levels, although the importance of each layer of the pyramid will vary across households.

MAJORITY OF AMERICANS HAVE RETIREMENT SAVINGS

As of March 31, 2014, retirement assets have grown to \$23.0 trillion.³ According to the 2014 *Investment Company Institute Fact Book*, "sixty-seven percent of U.S. households (or 82 million households) reported that they had employer-sponsored retirement plans, IRAs, or both in May 2013."⁴ Such resources represent an important component of Americans' retirement resources.

Despite the growth in retirement assets and in the number of households with retirement accumulations, there are some Americans who are not on track to be prepared for retirement. As a result, retirement policies should identify those individuals who are not making use of existing

¹ See American Council of Life Insurers, American Benefits Council, and Investment Company Institute, *Our Strong Retirement System: An American Success Story* (December 2013), available at www.ici.org/pdf/ppr_13_strong_retirement.pdf.

² See Brady, Burham, and Holden, "The Success of the U.S. Retirement System," *ICI White Paper* (December 2012), available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

³ See Investment Company Institute, "The U.S. Retirement Market, First Quarter 2014" (June 2014), available at www.ici.org/info/ret_14_q1_data.xls.

⁴ See Chapter 7 in Investment Company Institute, 2014 *Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry* (2014), available at www.icifactbook.org/fb_ch7.html.

retirement vehicles and be targeted to helping such individuals overcome the barriers that are keeping them from getting on the path to a financially secure retirement. Moreover, any policy initiatives considered in the context of tax reform or deficit reduction should be carefully vetted to ensure that they won't have the unintended negative consequence of reducing retirement preparedness.

TAXES ARE DEFERRED

The Joint Committee on Taxation (JCT) estimates that tax benefits for retirement savings represent one of the largest tax expenditures in the Internal Revenue Code. As a result, some have argued that these tax incentives should be reduced or eliminated in the context of deficit reduction or comprehensive tax reform. However, it is important to recognize that tax incentives for retirement merely represent a *deferral* of tax. American savers receive tax benefits when accumulating retirement savings, but they pay tax – at ordinary income tax rates – when amounts are withdrawn during retirement. A recent study by the American Society of Pension Professionals & Actuaries (ASPPA) found that revenue estimates from the JCT and the Treasury Department's Office of Tax Analysis (OTA) overstated the true cost of retirement tax incentives by as much as 77 percent. According to the ASPPA study, *"The one-year present value tax expenditure estimates are 34 percent lower than the JCT estimates and 54 percent lower than the Treasury one-year estimates. Similarly, the one-year present-value tax expenditure estimates are lower than the Treasury one-year present-value estimates by approximately 77 percent."*⁵

Moreover, a reduction in retirement tax incentives could reduce plan formation and negatively impact retirement savings for Americans at all income levels, which could lead to increased reliance on Federal safety net programs.

DECREASING TAX BENEFITS WILL HARM LOWER-INCOME AMERICANS

In December 2010, the National Commission on Fiscal Responsibility and Reform released its report on federal deficit reduction. The report provided several illustrative examples of options for reducing the deficit through tax reform. One of the options included in the report would consolidate retirement accounts and cap annual tax-preferred total (employer and employee) contributions to DC plans to the lower of \$20,000 or 20% of income – an option that has come to be called the "20/20 plan."⁶

A recent study by the Employee Benefit Research Institute (EBRI) found that capping the tax benefit for retirement savings, as proposed under the 20/20 plan would reduce retirement security

⁵ See Xanthopoulos and Schmitt, *Retirement Savings and Tax Expenditure Estimates*, American Society of Pension Professionals & Actuaries (May 2011), available at www.asppa.org/Portals/2/APerspectiveOnTaxPolicyToPromoteRetirementSavingsMay2011.pdf.pdf.

⁶ See page 31 in The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth* (December 2010), available at www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

for workers at all income levels.⁷ According to the study, those in the lowest-income quartile (of all but the oldest age group) will experience the second highest average percentage reduction in retirement savings.⁸

Lower-income workers would be especially harmed by proposals that would reduce retirement tax incentives and discourage small businesses from offering retirement plans. In her written testimony submitted to this Committee, Judy Miller, testifying on behalf of ASPPA, stated that, *"Reducing the maximum contribution from the current \$49,000 to \$20,000 would mean the qualified retirement plan no longer makes financial sense for many small business owners. The result would be less access to retirement savings opportunities at work for rank and file employees. In a survey of "cross-tested" plans conducted by the American Society of Pension Professionals and Actuaries (ASPPA), 65% of plan sponsors indicated they were likely to terminate the cross-tested plan if the plan design were no longer available. A dramatic reduction in the limit would effectively make not only a cross-tested plan, but most other qualified defined contribution plans, unattractive to small business owners."*⁹

INVESTORS WANT AND VALUE RETIREMENT SAVINGS TAX INCENTIVES

A wide range of research demonstrates that Americans value and want to retain retirement savings tax incentives and that changes in the tax incentives could negatively impact savings behaviors.

- 83 percent of Fidelity retail customers indicated that retirement savings is an important tax benefit that they want Congress to protect.¹⁰
- A fall 2013 survey of more than 3,000 U.S. households found that 86 percent of all households do not want the government to take away DC tax benefits and 83 percent rejected the idea that the amount individuals can contribute to DC accounts should be reduced.¹¹
- In the fall of 2013, 87 percent of DC account-owning households indicated the tax treatment of their DC plan was a big incentive to contribute.¹²

⁷ See VanDerhei, "Tax Reform Options: Promoting Retirement Security," *EBRI Issue Brief* (November 2011), available at www.ebri.org/pdf/briefspdf/EBRI_IB_11-2011_No364_RetTaxRfm.pdf.

⁸ *Ibid*, Figure 2.

⁹ See page 14 in Miller, "Testimony Submitted by Judy A. Miller on behalf of the American Society of Pension Professionals and Actuaries, Senate Finance Committee Hearing: Tax Reform Options: Promoting Retirement Security" (September 15, 2011), available at www.finance.senate.gov/imo/media/doc/Testimony%20of%20Judy%20Miller.pdf.

¹⁰ March 2011 Fidelity Survey – Online Survey of Fidelity Retail customers using the Customer Advisory Panel fielded March 9 to March 22, 2011

¹¹ See Figure 3 in Burham, Bogdan, and Schrass, "Americans' Views on Defined Contribution Plan Saving," *ICI Research Report* (January 2014), available at www.ici.org/pdf/ppr_14_dc_plan_saving.pdf.

¹² *Ibid*, Figure 2.

- The 2011 EBRI Retirement Confidence Survey (RCS) found that lower-income workers are more likely to reduce the amount of contributions made to their retirement savings accounts if the tax deduction were to be eliminated.¹³

INDIVIDUAL RETIREMENT ACCOUNTS

The Savings Coalition of America has actively supported the expanded Individual Retirement Account (IRA) provisions that increased contributions to spousal IRAs from \$250 to \$2000 in 1996; the establishment of the SIMPLE IRA in 1996; the increased income limits for IRAs and the establishment of the Roth IRA in 1997; and the increase in contribution limits for IRAs and the creation of catch up contributions in the 2001 tax bill and making these provisions permanent in 2006. Retirement savings is a key component of economic policy, and IRAs, which had \$6.6 trillion in assets at the end of March 2014,¹⁴ are a vital part of retirement savings.

In 2001, the Congressional Joint Committee on Taxation made recommendations for tax simplification in which it discussed the elimination of income limits on all IRAs and the elimination of the age requirement for required minimum distributions and described the complexity surrounding these sections of the tax code.¹⁵ The Coalition shares the view that these sections of the tax code are complex and confusing and urges the Committee on Finance to review them.

Universally Available IRAs

Currently the tax code includes a number of income limits for eligibility to contribute to IRAs. In addition to different income limits for single and married Americans, there are different income eligibilities for the traditional, deductible IRA, the Roth IRA, and the nondeductible IRA. The lesson that we learned in the early 1980s, when IRAs were universally available to all Americans, is that more Americans contributed to IRAs.¹⁶ The universal eligibility led to mass marketing of these savings vehicles, which increased participation and saving in IRAs. When income limits were imposed after the Tax Reform Act of 1986, there was a precipitous drop in

¹³ See Figure 4 in VanDerhei, "The Impact of Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income: Results from the 2011 Retirement Confidence Survey," *EBRI Notes* (March 2011), available at www.ebri.org/pdf/notespdfs/EBRI_Notes_03_Mar-11.K-Taxes_Acct-HP.pdf.

¹⁴ See Investment Company Institute, "The U.S. Retirement Market, First Quarter 2014" (June 2014), available at www.ici.org/info/ret_14_q1_data.xls.

¹⁵ See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification Pursuant to Section 8022 (3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System* (April 2001), available at www.jct.gov/s-3-01vol2.pdf.

¹⁶ See Holden, Ireland, Leonard-Chambers, and Bogdan, "The Individual Retirement Account at Age 30: A Retrospective," *Investment Company Institute Research Perspective* (February 2005), available at www.ici.org/pdf/per11-01.pdf.

contributions to IRAs.¹⁷ The 1986 experience teaches us that limiting IRA eligibility based on income confuses people and scares them away from establishing a pattern of savings that IRAs would otherwise promote. One of the most important effects of the IRA cutbacks in the Tax Reform Act of 1986 is the fact that IRA contributions for those who continued to be eligible for deductible IRAs dropped by more than 40% in the first year and have since dropped by over 65%.

Members of the Savings Coalition believe that eliminating income limits and creating a universally available IRA will help more Americans save. An IRA that is universally available to all American workers would leave no doubt to their understanding of their eligibility. Universally available IRAs will be marketed and advertised on a massive scale and this advertising will have an ancillary benefit of educating people about the need to save. History demonstrates that the simpler it is to save for retirement, the more Americans are inclined to do so.

Under current law, deductible IRA and Roth IRA contribution eligibility is determined based on whether a taxpayer falls under or between certain income thresholds, and for deductible IRAs, whether the taxpayer or the spouse, has access to an employer-sponsored retirement plan – a so called active participant.¹⁸ The 2014 income thresholds for the deducting IRA contributions are \$60,000 - \$70,000 for single taxpayers and \$96,000 - \$116,000 for married couples filing a joint return. If the taxpayer does not have access to a plan but the spouse does, the phase-out range is \$181,000 - \$191,000 for joint filers. Roth eligibility thresholds are \$114,000 - \$129,000 for single individuals and \$181,000 - \$191,000 for married couples filing a joint return. No income limits apply to single taxpayers and married couples where neither spouse is an active participant for deductible IRAs. Taxpayers making excess contributions are subject to penalties.

Another area of confusion for joint filers is that eligibility for making deductible contributions also depends on participation in an employer-sponsored plan in addition to income. If one spouse is covered by an employer plan and the other is not, as long as their income is below \$181,000, the non-covered spouse is eligible to make a fully deductible traditional IRA contribution. The deductibility of the contribution is phased out between \$181,000 and \$191,000. If they are both covered, then the phase out in place is between \$96,000 and \$116,000. Income is also considered for making a Roth IRA contribution. If income exceeds the limits, the person simply cannot make a contribution. Also, if a person is not covered, or neither spouse is covered by an employer plan, then there is no income limit to making a traditional deductible IRA contribution. Again, this adds a layer of complexity and confusion to already complex eligibility requirements which can discourage Americans from making use of these important savings vehicles.

Simplifying IRAs would encourage more participation. Then, participants could take advantage of direct deposit and other tools that have been shown to facilitate saving. The confusing array of income limits discourages many workers from establishing and contributing to IRAs. This

¹⁷ *Ibid*, Figure 3.

¹⁸ For IRA contribution eligibility rules, see Internal Revenue Service, *Publication 590*, available at www.irs.gov/pub/irs-pdf/p590.pdf.

simplification will lead to less confusion for taxpayers and likely encourage more marketing of IRAs by financial institutions, which in turn will lead to greater awareness.

Members of the Savings Coalition of America feel that any changes to the retirement system should encourage Americans to take more responsibility for their retirement preparedness. One way in which this can be achieved is to promote values that we all share; such as savings and thrift. When it comes to savings, our tax code should encourage Americans to save for their futures and make it easier to do so. The variety of income limits for current tax-favored IRAs are cumbersome and confusing and we encourage the Committee to recommend substantial simplification in this area. Provisions that encourage individually responsible behavior such as savings should apply to all Americans. Our current tax-favored savings vehicles already limit the amount that can be saved. We should not limit eligibility of the people who can save through them. That just makes them more confusing.

Required Minimum Distributions

Under present law, Americans who reach age 70½ must begin taking required minimum distributions (RMDs) from their non-Roth IRAs.¹⁹ One unintended consequence of the requirement is that individuals may be forced to take a distribution at a time when their investment has declined in value. Over the past several years, many retirees and workers about to retire have seen a drop in the value of their retirement nest eggs. Those subject to the requirement may be forced to realize losses on part of their investments at a time when they can least afford to do so. The RMD rules merely determine when taxes will be imposed on retirement savings, not if. When the IRA owner withdraws funds, it will be taxed as ordinary income.

In addition, tax reform should take into account such things as a longer life expectancy for most Americans. U.S. life expectancy rates have increased substantially since the RMD rules were first extended to all types of retirement plans. According to the Social Security Administration (SSA) Period Life Expectancy Table, the life expectancy of a person aged 65 in 2013 is four and a half years longer for men and nearly three years (2.8) longer for women than it was in 1974,²⁰ the year that IRAs were created. For 2013, SSA estimates that a man aged 65 can expect to live to age 83.0 and a woman aged 65 can expect to live to 85.5.²¹ With such substantial increases in longevity, it is important that the RMD rules be updated to ensure that American workers are not forced to take distributions prematurely.

Critics also overlook recent trends in the numbers of seniors working past the age of 65 and into their seventies. According to the U.S. Bureau of Labor Statistics, in 2012 the civilian labor force

¹⁹ For this purpose, “non-Roth IRAs” includes traditional IRAs, SEP IRAs and SIMPLE IRAs.

²⁰ See 2014 *OASDI Trustees Report*, Table V.A3. Period Life Expectancy, Social Security Administration, available at www.ssa.gov/oact/TR/2014/lr5a3.html#hist.

²¹ *Ibid.*

participation rate of people aged 65 or older was 18.5 percent.²² The civilian labor force participation rate of people aged 65 or older is up more than 60 percent from 1992, when it was 11.5 percent of people aged 65 or older.²³ With the recent market downturn, many workers decided to put off their retirement. According to a fall 2010 survey of 3,000 U.S. households, 16 percent of households delayed retirement or increased their expected retirement age in response to the financial stresses of the prior three years,²⁴ which will contribute further to the numbers of seniors in the workforce. It is shortsighted policy to force distributions from retirement accounts when seniors are pushing back retirement dates to ensure they will have enough to live comfortably throughout their retirement years. As Americans live longer, the RMD rules need to be changed to reflect gains in life expectancy.

CONCLUSION

Workplace retirement plans, which combine tax incentives for retirement savings with employer matches and other features, such as auto enrollment and auto escalation, are extremely effective tools for increasing retirement saving and enhancing retirement security. The tax deferral that these plans offer is different from a tax deduction or tax exclusion; taxes are paid when distributions are taken from the plans. The system can be further strengthened through financial literacy and education about the existing programs and incentives, small business retirement plan enhancements and IRA reforms. The Savings Coalition supports the Committee on Finance's goal toward financially secure retirements for Americans and offers its assistance in this effort. We look forward to working with you to build on the strong U.S. retirement savings system.

²² See Table 3 in Toossi, "Labor force projections to 2022: the labor force participation rate continues to fall", *Monthly Labor Review* (December 2013), available at www.bls.gov/opub/mlr/2013/article/labor-force-projections-to-2022-the-labor-force-participation-rate-continues-to-fall.htm.

²³ *Ibid.*

²⁴ See Holden, Bass, and Reid, "Commitment to Retirement Security: Investor Attitudes and Actions," *ICI Research Report* (January 2011), available at www.ici.org/pdf/ppr_11_com_ret.pdf.

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**SMALL BUSINESS COUNCIL OF AMERICA AND SMALL BUSINESS LEGISLATIVE COUNCIL
STATEMENT FOR THE RECORD
U.S. SENATE FINANCE COMMITTEE HEARING
“RETIREMENT SAVINGS 2.0: UPDATING SAVINGS POLICY FOR THE MODERN ECONOMY”
SEPTEMBER 16, 2014**

The Small Business Council of America (SBCA) and the Small Business Legislative Council (SBLC) appreciate the opportunity to submit this statement.

The SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 successful enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans for their employees. The SBCA is fortunate to have many of the leading small business advisors in the country on its Advisory Boards, many of whom are the leading experts in employee benefits law and how that law impacts small and family-owned businesses.

The SBLC is a 35 year old permanent, independent coalition of over 50 trade and professional associations that share a common commitment to the future of small business. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. SBLC policies are developed by consensus among its membership.

INTRODUCTION:

Longer life expectancies are requiring increased retirement savings. Individuals of all economic levels are far more likely to adequately save for their retirement if they participate in some form of retirement plan. According to research done by the Employee Benefits Research Institute (EBRI) for the American Society of Pension Professionals and Actuaries (ASPPA), **workers are 14 times more likely to save in a retirement plan offered by their employer than to save through an IRA.**¹ By using payroll deductions, employer sponsored retirement plans encourage savings because they automatically remove the money before it ever goes into the employee's pocket.

The retirement security of our nation's employees is intended to rest primarily upon three sources – often referred to as the three legged stool – Social Security, the voluntary private retirement system and individual savings. As we know, Social Security is basically a defined benefit system and payments are based upon an annuity type of framework – i.e., one cannot outlive payments from Social Security. By design there is very little flexibility in this system and it was primarily designed to serve as a safety net. The voluntary private retirement system is now primarily based on a defined contribution system and the methods of payments can include

¹ The American Society of Pension Professionals and Actuaries, Tax Reform Shouldn't Harm Main Street's Retirement Plan (April 19, 2013), <http://www.asppanews.org/2013/04/19/tax-reform-should-not-harm-main-streets-retirement-plan/>

annuities, installments (most often through an IRA), lump sums or a combination of one or more of these methods. The private retirement system, though highly regulated by the Department of Labor and the Internal Revenue Service, contains sufficient flexibility to allow an employer to design a retirement plan that fits the needs of the employer and its employees.

Today there is concern for the viability of the Social Security system, though most experts believe that with some relatively minor, but probably politically painful, shoring, it could be kept viable for the foreseeable future. Regardless, Social Security should not be solely relied on for retirement security. The Social Security Administration reported that, in 2012, the average annual social security benefit for a retired worker was \$14,760.

Thankfully, the second “leg of the stool” – the private retirement system – is doing quite well. This success is primarily the result of a series of laws (sometimes referred to as the “Portman-Cardin” laws) which recognized that the system had become too complex and costly without providing enough upside for small and mid-size businesses to join it and largely corrected those problems. As reflected in the ASPPA statistic cited above, a significant portion of our individual savings are done inside a 401(k) plan, 403(b) plan or SIMPLE IRA. This fact holds true not only for wealthier individuals but also for the average American worker. 71.5% of individuals who make between \$30,000 and \$50,000 contribute to an employer plan when offered, whereas only 4.6% of individuals in the same income bracket contribute to an IRA.²

It would appear that there are at least three factors responsible for the success of employee saving in retirement plans. First, it is clear that payroll deduction is an “easy” or “painless” way to save. It is done automatically by the employer and thus, the employee does not have to do anything to get the money into the savings vehicle. Second, it is easier not to spend money or conversely to save it when one does not have it in his/her pocket. Third, with respect to the 401(k) and 403(b) plan, the employee does not have easy access to the saved money so that it continues to grow tax free.

The availability of retirement plans is therefore central to helping employees save. When an employer offers a retirement plan, most employees will participate. These high “take-up” rates are true regardless of the size of the employer. A recent study,³ which used actual data from employees’ W-2 forms, found that **81% of employees working for employers with 100 or more employees take advantage of an offered retirement plan and that 79% of employees working for employers with less than 100 employees take advantage of being able to make employee contributions into the qualified retirement plan.** Although these rates are good, maintaining and continuing to increase these numbers is important.

Auto-enrollment, which automatically enrolls an employee in the plan unless they opt out, and auto-escalation, which automatically increases an employee’s contribution to the plan unless they opt out, are important options that an employer can utilize to increase employee

² The American Society of Pension Professionals and Actuaries, Save My 401(k) Fact Sheet, <http://asppa.org/save-my-401k-factsheet>

³ Dushi, Iams and Lichtenstein, Social Security Bulletin, Vol. 71 No.2 2011, Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Tax Records.

participation in a plan. The success of auto enrollment and auto escalation is somewhat startling.⁴ Those of us in the trenches believe that inertia is the key to their success – i.e., an employee would rather stay enrolled in a retirement plan because it is easier to do so than to opt out and it is easier for employees to allow the amount of their contributions to increase over a number of years than to affirmatively take steps to decrease the amount. Additionally, educating the entire workforce, particularly the younger workers, of the importance of saving for retirement is key to maintaining the high take-up rates that we see today.

Because employees save better in a retirement plan, and because employees are likely to participate in a plan when given the option, encouraging employers to sponsor retirement plans is critical in creating retirement stability.

Small businesses face particular challenges when it comes to sponsoring retirement plans. Small businesses have long been at the heart of the American economy. However, small business owners are focused on the challenges of maintaining their businesses and the relative cost of sponsoring a plan is greater for small businesses than it is for large companies. In 2012, the Small Business Administration reported that only about half of new businesses survive their first five years and only about a third of new businesses survive 10 years or more.⁵ **No matter how much a small business owner cares about his or her employees, offering a retirement plan is often a secondary concern to the survival of the business and the decision of whether to offer a plan comes down to a cost benefit analysis. Once small businesses survive the initial period of uncertainty and become more established they are far more likely to sponsor a retirement plan.**

Despite the challenges, many small businesses still offer plans and make meaningful contributions for their employees. Unfortunately, there is a problematic misconception that plan sponsorship among small businesses is very low. **In fact, the small business qualified retirement plan system has been quite successful in providing retirement security for its workers. In the study⁶ which used actual data from employees' W-2 forms, the researchers found that 77% of all employees who work in companies with 10 or more employees are offered a retirement plan and that of these employees, 62% made 401(k) contributions.**⁷

⁴ Jack VanDerhei and Lori Lucas, The Impact of Auto-enrollment and Automatic Contribution Escalation on Retirement Income Adequacy, Employee Benefits Research Institute, Issue Brief No. 349 (November 2010), http://www.ebri.org/pdf/briefspdf/EBRI_IB_011-2010_No349_EBRI_DCIIA.pdf

⁵ Frequently Asked Questions, Small Business Administration, Office of Advocacy (September 2012), available at http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf

⁶ Dushi, Iams and Lichtenstein, Social Security Bulletin, Vol. 71 No.2 2011, Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Tax Records.

⁷ It is interesting to note that the reason why this study shows higher retirement plan coverage than is reflected in other studies is because this study relied upon actual W-2 data to determine if an employee was covered by a plan. Most other studies have relied upon surveying employees to find out if they were covered by a retirement plan. Once again, those of us experienced in this area are not surprised by the marked discrepancy between employees who report they are not covered by a plan compared to the actual data. One would think that an employee would know if he or she was making employee contributions into the plan but this is not the case. Perhaps even more obscured for many employees is that their employer is making contributions for them whether through a match or by

The size of the company makes a significant difference. W-2 data reflects that 46% of small businesses with more than 10 employees but less than 25 offer a retirement plan. The same data reflects that 60% of small businesses which employ 25 employees but less than 50 offer a retirement plan. 70% of small businesses which employ 50 employees but less than 100 offer a retirement plan. 84% of businesses with more than 100 employees offer a retirement plan. There is no further breakdown given for over 100 employees so we do not know how many small to mid-size businesses – often defined as up to 500 employees offer plans compared to the larger businesses.

In light of the cost to a small business of offering a plan and the large number of employees who are actually covered by the qualified small business retirement plan system, any changes that would make plan sponsorship more costly or burdensome, or otherwise motivate employers to freeze or eliminate the plans could have significant and detrimental long term repercussions. This is highlighted by considering the demographics of the employees who participate in retirement plans – nearly 80% of all plan participants make under \$100,000 per year and 43% of all participants make less than \$50,000 annually.⁸

WHAT MOTIVATES SMALL BUSINESSES TO SPONSOR PLANS?

There are a number of elements that small business owners weigh when deciding whether to sponsor a plan. Small businesses have a unique place in the qualified retirement plan system. Unlike large businesses, most small businesses are closely held and most small business owners do not anticipate being able to sell their businesses as a means of funding their retirement. Also, the non-qualified deferred compensation plan heavily utilized for key management employees in larger businesses is not available to smaller businesses because of unfavorable tax treatment. **Because of this, one of the primary motivations for small business owners to sponsor a plan is that participating themselves is the best way to save for their own retirement. Most small business owners view the costs of sponsoring a plan and the meaningful contributions that are made for the non-key employees as the price of admission to be able to save in a qualified retirement plan for themselves. Employee recruitment, retention and morale are also positive factors that the owners take into account when deciding whether to sponsor a plan.**

There are, however, significant costs for a small business to sponsor a plan. **Thus, a small business owner's decision of whether to create or continue to sponsor a plan often comes down to a cost benefit calculation. In short, the benefit to be derived by the business owners must equal or exceed the costs and burdens of sponsoring the plan in order for the owners to decide to adopt a qualified retirement plan.** Some of the factors taken into account by small business owners when deciding to sponsor a retirement plan include the employees' preference for cash or health care coverage (i.e., lack of appreciation by the employees for contributions made by the employer into the retirement plan for their benefit), the uncertainty of the business' revenue from year to year, the costs of setting up the plan and the ongoing costs of

a non-elective employer contribution (aka profit sharing contribution).

⁸ The American Society of Pension Professionals and Actuaries, Save My 401(k) Fact Sheet, <http://asppa.org/savemy401kfactsheet>

administering it and the amount of the required company contributions for the staff employees. When asked what could break down these barriers, the following answers are often given by small businesses: repeal the top-heavy rules, reduce administration, and change the lack of employee demand by educating employees about the need to save for their retirement now. Some small business owners report that until they are more profitable and stable, nothing will convince them to sponsor a retirement plan. We consistently hear from our members **that any decrease to the owners' and key employees' level of benefits would significantly affect their cost-benefit analysis and cause many to walk away from sponsoring a retirement plan.**

Some small business owners engage in this cost benefit analysis on their own, while many rely on accountants and other financial advisors to help them weigh the pros and cons of sponsoring a plan. **The success of the small business retirement system is largely dependent on federal tax laws. The contribution limits for both employees and employers and the tax deferrals are usually central to tipping the scale in favor of plan sponsorship.** Reducing the amount that can be contributed to a retirement plan, as some proposals have suggested, may cause small business owners to determine that, from a tax viewpoint, it is better to close down the plan and take out the extra funds as compensation or reinvest them in the business. Funds taken out as compensation could then be invested in capital gain assets which receive a step up in basis at death or in insurance which gives rise to favorable tax treatment.

A criticism sometimes aimed at the retirement plan system is that the contributions for the non-highly compensated are not significant. Practitioners who work with qualified retirement plans know better, at least as far as small businesses are concerned. If the highly compensated employees, including the owner, are going to receive meaningful benefits, the rules governing the qualified retirement system require the employer to also make meaningful company contributions for all non-highly compensated employees. Since a major goal of a retirement plan is to provide retirement security for the owners (and in most cases, is the only way they can save for retirement through their company), it is not at all unusual for a small business to contribute in the range between 3% and 10% of compensation for the non-highly compensated employees. This means that it is not unusual for a small business employee to, in effect, receive a bonus, albeit one given to the retirement plan, in an amount of at least 3% of their annual compensation but often equal to 5%, 7.5% or even 10%.

In the recent discussions on how to raise revenue (and conceivably lower tax rates through tax reform), the deduction for retirement plan contributions has been treated the same as other tax expenditures in the tax code. This is a mischaracterization because retirement plan contributions are eventually brought into income, along with any earnings.⁹ There are approximately 670,000 private-sector defined contribution plans covering approximately 67 million participants and over 48,000 private-sector defined benefit plans covering approximately 19 million participants. The U.S. private retirement plan system paid

⁹ A study prepared for the American Society of Pension Professionals & Actuaries reflects the value of the retirement plan tax expenditure to be roughly 55 – 75% lower than estimates by the Joint Committee and the Treasury. This study assumes that people will enjoy lower income tax rates during retirement than when contributions are made to the retirement plan. This assumption, increases the value of the “tax expenditure.” Many experts believe, however, that tax rates are going to be higher for most taxpayers in the future and that the “real” cost of the retirement plan tax expenditure is even lower than that set forth in the ASPPA report. Xanthopoulos and Schmitt, Retirement Savings and Tax Expenditure Estimates, ASPPA May, 2011.

out over \$3.824 trillion in benefits from 2000 through 2009 and U.S. public sector plans paid out \$2.651 trillion during the same period. All of this money was brought into income and subject to regular income tax rates (the only exception would be money that was contributed on an after-tax basis). **The only loss to the government with respect to the deduction for retirement plan contributions and tax free growth inside the plan is the time value of money. But the potential detrimental impact on savings by Americans due to a reduction on contributions to retirement plans could be huge.**

Like contribution caps, changes that discourage savings are not a move in the right direction. A number of recent proposals would amend the laws to require that retirement plan assets be forced out of a plan shortly after the passing of both spouses. Such proposals to eliminate the “stretch IRAs” (which allows the amount remaining in an IRA at an employee’s death to be distributed over the life expectancy of the beneficiary(ies) who inherit it), will cause people to be wary of accumulating “too much” retirement money because of its ultimate undesirable tax treatment. This may cause employees to under save for their retirement and could further give rise to small business owners freezing contributions or closing down the whole plan. It is important to many individuals, including small business owners, who have accumulated funds that they can name their children as beneficiaries. With the “stretch IRA” employees can invest in an IRA not only to secure their own retirement future but knowing that any remaining funds can provide their children with a safety net by allowing them to take the funds out of the IRA over their lifetimes rather than being forced to take the funds out in a lump sum as called for in this proposal.

SIMPLIFYING THE RETIREMENT PLAN SYSTEM TO MOTIVATE PLAN SPONSORSHIP:

A major disincentive for a small business owner to sponsor a plan is the heavy administrative requirements (such as notice requirements, top-heavy rules and discrimination testing) which can often be very burdensome for the employer and tip the scales against sponsoring a plan. Many of these administrative requirements could be eliminated or simplified without negatively impacting the participants.

Repeal or Revise Top-Heavy Rules

One of these areas which is ripe for simple and meaningful changes is the top-heavy rules for defined contribution plans. When first enacted the top-heavy rules imposed additional minimum contributions and accelerated vesting on small and mid-size retirement plans which were almost always top-heavy due to the mathematical tests used to determine such status. Over the years, the rules have changed so significantly that the top-heavy rules are now an archaic appendage similar to that of the appendix in the human body – they do nothing but cause problems.

An inaccurate perception that the top-heavy rules still operate so as to benefit non-highly compensated employees has resulted in inertia on the Hill when it comes to repealing these unnecessary and complicated rules. While an outright repeal would be most effective, the following proposals have been developed so as to try to ameliorate the more negative aspects of the top-heavy rules.

One way to improve the system would be to eliminate top-heavy contributions for plan participants with less than one year of service so that employees are allowed to make 401(k) contributions during their first year. Because of the top-heavy rules, small and mid-size plans that are top-heavy cannot allow recent employees into the 401(k) portion of their profit sharing plan without these employees receiving an employer contribution even though they have not met the requirements for the regular “profit sharing contribution.” Thus, even though from a policy viewpoint we would want to encourage new hires to start saving for their retirements as soon as possible, the top-heavy rules do not allow this result. Enactment of the change above will result in more participation in the 401(k) plan sooner rather than requiring employees to be at the company for a year before being able to enter the 401(k) portion of the retirement plan. The one year wait is the “typical” wait for eligibility for entry into small retirement plans and this is because of the top-heavy rules. Eliminating the wait would allow more small business employees to start participating in the 401(k) portion of the plan sooner.

401(k) plans are a tremendous success story. Prospective employees ask potential employers if they have a 401(k) plan and if so, what the investment options are and how much does the employer contribute. Employees meet with investment advisors to be guided as to which investments to select, employees have 800 numbers to call or websites to visit to see how their investments are doing and to determine whether they want to change investments. Employees discuss among themselves which investment vehicles they like and how much they are putting into the plan and how large their account balances have grown. **It is probably not an exaggeration to say that the 401(k) plan brought Wall Street to main street and that it has provided employees with the education needed to effectively invest.**

The forced savings feature of the 401(k) plan cannot be underestimated and must be safeguarded. When a person participates in a 401(k) plan, he or she cannot remove the money on a whim. Some retirement plans allow savings to be removed by written plan loan which cannot exceed 50% of the account balance or \$50,000 whichever is less. Savings can be removed by a hardship distribution, but this is a tough standard to meet. The distribution must be used to assist with a statutorily defined hardship such as keeping a house or dealing with a medical emergency. This is in contrast to funds inside an IRA or a SIMPLE IRA (an employer sponsored IRA program) where the funds can be accessed at any time for any reason. True, funds removed will be subject to an early withdrawal penalty (which is also the case for a hardship distribution from a 401(k) plan), but anecdotal data suggests that individuals freely access IRAs and SEPs (also an employer sponsored IRA program) and that the early withdrawal penalty does not seem to represent a significant barrier. Nevertheless, there is a distinct difference between asking the employer for a loan or a hardship distribution and having to jump through some statutorily and well placed hoops versus simply removing money at whim from your own IRA.

Another change would be to allow small and mid-sized companies to sponsor employee pay-all 401(k) plans without the 401(k) contributions made by key employees triggering the top-heavy rules. Under current IRS regulations, when a key employee makes a 401(k) contribution, that employee contribution is deemed to have been made by the company and the company is then required to make top-heavy contributions for the non-key employees. Because of this rule, small to mid-size employers who would like to offer 401(k) plans must

either commit to make company contributions to non-key employees or to exclude key employees from participation in the 401(k) plan. Many companies cannot afford to make company contributions and most owners will be unmotivated to offer plans in which they, and other key employees, cannot participate. Thus, from a policy viewpoint, employees who might have made 401(k) contributions are not given the opportunity because of the significant barriers that stand before small to mid-size companies offering this type of plan. **Many members of Congress seem to not understand that most small business owners are not interested in incurring additional expenses and administrative burdens if there is no upside for them. Employees of small or mid-sized employers would certainly be far better off having an employee pay-all plan, in which both key and non-key employees could contribute without creating a required contribution for the company, than having no plan at all.** Under such a scenario, the regular anti-discrimination tests would still apply to offer protection for non-key employees. Larger companies (which because of the mathematical tests are never top-heavy) can sponsor employee pay-all 401(k) plans. This rule unfairly discriminates against small businesses and their employees. A change to this rule would allow more small business employees access to a 401(k) plan and level the playing field between larger and smaller business entities.

Simplify ADP Testing

Another area ripe for simplification is the 401(k) discrimination testing, known as the “ADP” tests. The anti-discrimination rules for 401(k) plans (the ADP tests) are more complicated than needed. For instance, the tests set forth in the proposal referred to as the “ERSA” (Employer Retirement Savings Accounts) would satisfy the policy goals of the ADP while reducing some of the complexity currently inherent in these tests. This could be an optional ADP test so that companies who are able to deal with the current ADP tests are not required to change retirement plan documents, software and procedures.

The ERSA proposal calls for the contribution percentage for eligible highly compensated employees (HCEs) for the plan year not to exceed 200% of such percentage for the non-highly compensated employees (NHCEs) if the contribution percentage of the NHCEs does not exceed 6%. If the contribution percentage of the NHCEs exceeds 6%, then no testing would be required. The proposal also has two safe harbors to avoid the simplified nondiscrimination test which are similar to the current 401(k) safe harbors.

Eliminate Safe Harbor Notices for 401(k) Safe Harbor Match and 3% Non-Elective Safe Harbor Notices

These notices, both required by statute, are costly and burdensome. The match safe harbor notice does serve a policy purpose in that it can affect the amount of 401(k) deferrals an employee may choose to make in order to receive the match. However, rather than yearly notices, the notice could stay in effect unless and until revoked. The notice could be part of the Summary Plan Description.

The safe harbor notice for the 3% non-elective safe harbor serves no policy purpose at all and should be eliminated as soon as possible. Eliminating these unnecessary notice requirements would reduce the burdensome paperwork that pose a barrier to small businesses sponsoring a plan.

Eliminate Required Minimum Distributions (RMDs)

It makes no sense to require individuals to remove funds from an IRA or retirement plan prior to their retirement or when not needed. **Presently the law requires small business owners (and only small business owners) to start receiving RMDs while they are working. The demographics of the group comprised of small business owners are such that money saved in a plan or an IRA will be crucial to their retirement security.**

Further, all IRA owners must start removing money from their IRAs whether needed or not by April 1st following the calendar year in which they attain the age of 70 ½. Life expectancy appears to be increasing dramatically, particularly for the oldest sectors of our population. There is no reason why the tax code should be forcing people to remove money that is intended to provide retirement security before it is needed. Worse, it is likely that the withdrawn money will be spent rather than growing tax deferred inside the IRA. It is essential that the money be available to the IRA owners when they reach the ages of 85, 90 or beyond.

Eliminating required minimum distributions and allowing participants more control after the age of 59 ½ will also help to simplify the tax code. At a minimum, the lifetime RMD requirements should be eliminated with RMDs required post-death (similar to Roth IRAs). If the RMD rules are not eliminated, the 70 ½ beginning date should at very least be pushed back to 75. All of the ideas above would help to ensure that individuals will have enough savings for their retirement taking into account increasing longevity so they will not have to rely upon the government for their welfare. The goal is to keep the money in the IRA or plan for as long as possible until needed. One way of encouraging people to keep their money in the plan or IRA for as long as possible would be to have RMDs taxed at capital gains rates once the IRA owner has reached a certain age – say 80.

Allow “KidRoths”

Considering the amount of money that an individual must put away to have adequate retirement savings when the time comes, it is important to encourage retirement savings to commence as early in life as possible.

Theoretically children are allowed to fund IRAs, however, in order to do so these children must have earned income, which most do not. Eliminating the earned income requirements for individuals under the age of twenty-one would permit these children to begin saving early in Roth IRAs and would allow parents, grandparents and other friends and family to make gift contributions up to the Roth IRA contribution limit to fund the child's IRA.

Bring Interim Amendments Under Control

When making any changes in the retirement plan area Congress should include a direction to the IRS that no amendments are to be required on the new law, including regulations on the new law, for a period of at least 3 years, or better until the next required restatement of the plan document. Summary of material modifications would still be required for changes requiring such notice to the plan participants. This change would make plans less expensive and burdensome to maintain while imposing no hardship on the plan participants.

Eliminating the Independent Audit Requirement for Plans with Assets Under \$5 Million

Even if a plan has relatively few assets, it may still have a large enough group of participants to trigger the independent accountant audit requirement. These audits generally cost between \$10,000 and \$20,000 annually. This cost is a disproportionate and expensive burden for the plan sponsor when the plan's assets are relatively small. It also discourages smaller employers from forming or maintaining a plan once it has more than 120 participants. The measure of the plan participants that can trigger the audit requirement is performed at the beginning of the year before any testing can be performed to identify if this is an issue. The independent audit requirement already includes an exemption for plans with a relatively small number of participants. There should also be a comparable exemption for plans with a relatively small amount of assets, not to exceed \$5 million.

Modify the QPSA Rules so that the Age 35 Requirement is Eliminated

The law now provides that a plan participant subject to the survivor annuity requirements of section 401(a)(11) generally may only waive the Qualified Pre-retirement Survivor Annuity (QPSA) benefit (with spousal consent) on or after the first day of the plan year in which the participant attains age 35. This provision does not promote any particular policy goals and is exactly the type of unnecessary provision that should be eliminated.

CONCLUSION:

The sine qua non of small businesses is private ownership with any year end surplus revenues (i.e., profits) flowing to the owners of the business. Each year, the owners can choose to reduce the profits by paying themselves additional taxable compensation and/or they can retain the profits inside the company and "grow" the business and/or they can contribute all or a portion of the profits to a retirement plan sponsored by the business. It is typical for the owners to weigh the tax consequences of these various options when deciding what to do with any excess revenues.

The viability of the small business retirement system is almost uniquely dependent upon the availability of sufficient tax incentives to the owners in order to offset the administrative costs of sponsoring a plan, the mandatory contributions for the non-owner employees required under the anti-discrimination rules set forth in the Internal Revenue Code and the fiduciary responsibility that comes with the plan. Thus, unless the owners come out ahead by making contributions to the retirement plan (taking into account the initial deduction for contributions made to the plan, the tax free growth, the eventual distributions being subject to regular income tax rates, the costs of running the plan and the costs of making the contributions necessary for staff employees) as compared to distributing the profit to the owners as taxable income and investing the net after tax compensation as they choose (with eventual favorable capital gains and/or dividend rates), small business owners are likely to forgo the retirement plan option.

Employer sponsored retirement plans are critical to ensuring widespread retirement security. Although small businesses face greater costs and barriers to sponsoring a retirement plan, the small business retirement system has been extremely successful in helping employees save for their retirement. This trend should be encouraged by promoting laws which simplify the system and cut down the costs on small businesses and rejecting proposals to eliminate the tax deductions and other benefits that motivate small businesses to sponsor plans.